



LEXSTAT 2-8B PATENT LICENSING TRANSACTIONS

Patent Licensing Transactions

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Appendix 8B: Tax Checklist

*2-8B Patent Licensing Transactions*A. Sale or exchange of patents under *IRC § 1235* ☐1. Definition of patent..... ☐a. The term "patent" is defined as: ☐(1) A patent granted pursuant to *35 USC § 1, et seq* ;
or ☐(2) Any foreign patent granting rights similar to those under a United States patent [Reg
§ 1.1235-2(a)]..... ☐b. It is not necessary that the patent or patent application for the invention be in existence if the
requirements of *IRC § 1235* are otherwise met [Reg § 1.1235-2(a)] ☐2. Definition of "holder" ☐a. The term "holder" is defined as [*IRC § 1235(b)*]: ☐(1) Any *individual* whose efforts created such property; or ☐(2) Any other *individual* who has acquired his interest in such property.....
☐(a) In exchange for consideration in money or money's worth paid to such *creator*
..... ☐(b) Prior to actual reduction to *practice* of the invention covered by the
patent..... ☐

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(c) Provided such other individual is neither..... ☐

(i) The employer of the creator, nor..... ☐

(ii) A person related to the creator within the meaning of *IRC* §§ 267(b) and 1235(d)
..... ☐

b. Although a partnership cannot be a "holder," each member of the partnership who is an individual may qualify as a holder as to his share of a patent owned by the partnership [Reg § 1.1235-2(d)(2)] ☐

c. An individual may qualify as a "holder" whether or not he is: ☐

(1) In the business of making inventions; or ☐

(2) In the business of buying and selling patents [Reg § 1.1235-2(d)(3)] ☐

3. Definition of "all substantial rights to patent" ☐

a. The term "all substantial rights to a patent" is defined
as: ☐

(1) All rights, whether or not then held by the
grantor ☐

(2) Which are of value at the time the rights to the patent (or an undivided interest
therein) are transferred [Reg § 1.1235-2(b)(1)] ☐

b. All substantial rights to a patent are not deemed to be conveyed in any grant which:.....
☐

(1) Is limited geographically within the country of issuance ☐

(2) Is limited in duration to a period which is less than the remaining life of the
patent..... ☐

(3) Grants to the grantee less than all the claims, rights, or inventions covered by the
patent which exist and have value at the time of grant [Reg § 1.1235-2(b)(1)], or
..... ☐

(4) Grants to the grantee all of the rights to use the patent in one field of

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application..... ☐

c. Whether or not all substantial rights to a patent are transferred depends upon the circumstances of the entire transaction rather than the particular terminology contained in the instrument ☐

d. The following are examples of rights which are not deemed substantial and may be retained by the holder [Reg § 1.1235-2(b)(2)]: ☐

(1) The retention by the transferor of legal title to the patent for the purpose of:..... ☐

(a) Securing payment or performance of the transferee's obligations ☐

(b) In a transaction involving the transfer of an exclusive license, to make, use, and sell the invention for the life of the patent ☐

(2) The retention by the transferor of a security interest in the property or a provision for forfeiture of rights on account of nonperformance ☐

e. The following are examples of rights which may or may not be substantial, depending upon the nature of the entire transaction [Reg § 1.1235-2(b)(3)]: ☐

(1) The transferor's retention of an absolute right to prohibit sublicensing or subassignment by the transferee; and ☐

(2) The failure to convey to the transferee the right to use or to sell the patent property..... ☐

f. The retention of a right to terminate the transfer at will is the retention of a substantial right [Reg § 1.1235-2(b)(4)] ☐

4. Nature of undivided interest..... ☐

a. A person owns an "undivided interest" in all substantial rights to a patent only when he owns the same fractional share of each and every substantial right to the patent [Reg §1.1235-2(c)]..... ☐

5. Transfer of rights to a patent ☐

a. A transfer by any holder to any person, other than a related person, of property consisting of: ☐

(1) All substantial rights to a patent; or ☐

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(2) An undivided interest thereof which includes all such rights is considered as a sale or exchange of a capital asset held for more than one year [*IRC* § 1235(a), (d); Reg § 1.1235-1(a)] ☐

b. A gift, inheritance, or devise of rights to a patent if not considered a "transfer" [*IRC* § 1235(a)]..... ☐

c. Payments in consideration of such transfer may (but need not) be: ☐

(1) Payable periodically over a period generally coterminous with the transferee's use of the patent, or..... ☐

(2) Contingent on the productivity, use, or disposition of the property transferred [*IRC* § 1235(a)] ☐

6. Payments to an employee-creator ☐

a. Section 1235 does not apply to payments received by an employee for services rendered under an employment contract which *requires* the employee to transfer his rights to any invention to his employer [Reg § 1.1235-1(c)(2)] ☐

b. Whether payments received by an employee (under an employment contract or otherwise) may be considered
as: ☐

(1) Compensation for services rendered to the employer; or ☐

(2) Attributable to the transfer by the employee of all substantial rights to a patent is a question of fact which must be determined on the merits of each case..... ☐

7. Payments by a transferee..... ☐

a. Payments made by the transferee of patent rights pursuant to a transfer, satisfying the requirements of *IRC* § 1235, are considered as payments of the purchase price for the patent rights and not a payment of royalties [Reg § 1.1235-1(d)] ☐

8. Other relevant Code provisions ☐

a. The tax consequences of transfers of patent rights which do not meet the requirements of *IRC* § 1235 are determined by other applicable provisions of the Internal Revenue laws [Reg § 1.1235-1(b); Rev Rul 69-482, 1969-2 CB 164]..... ☐

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B. Capital gains treatment under *IRC* §§ 1221-1223 ☐

1. Definitions of a "capital asset" ☐

a. The term "capital assets" includes all classes of property except, among others, the following:..... ☐

(1) Stock in trade, inventory, or property held for sale to customers in a trade or business [*IRC* § 1221(1)];..... ☐

and

(2) Property used in the trade or business of a taxpayer which is subject to the allowance for depreciation [*IRC* § 1221(2)] ☐

b. Where an individual transfers all substantial rights in a patent to a corporation in which he owns, directly or indirectly, 25% or more of the outstanding stock, then:..... ☐

(1) The transaction does not meet the requirements of *Section 1235 of the Internal Revenue Code* and is not eligible for long-term capital gains treatment because the transfer was to a corporation that is a related person within the meaning of *Section 1235(d) of the Internal Revenue Code* ☐

(2) However, it is the position of the Internal Revenue Service that where holders make transfers of patents that do not meet the requirements for capital gains treatment under *Section 1235 of the Internal Revenue Code*, the tax consequences of such transfers will be determined under other sections of the Internal Revenue Code [*Rev Rul 69-482, 1969-2 CB 164*] ☐

2. Sale or exchange..... ☐

a. In order to qualify for capital gains treatment, the transaction involved must constitute a "sale or exchange" of a capital asset [*IRC* § 1222]. Starting in 1988, however, capital gain will be taxed at the same rate as ordinary income (15% or 28%, depending on the applicable tax bracket), thereby ending preferential capital gains treatment ☐

b. A grant of patent rights, although in the form of a license, may constitute a sale [*Rollman v. Commissioner, 244 F.2d 634, 113 U.S.P.Q. 356 (4th Cir 1957)*] ☐

C. Capital gains treatment under *IRC* § 1231 ☐

1. Definition of "property used in the trade or business" ☐

a. "Property used in the trade or business" is: ☐

(1) Used in the trade or business ☐

(2) Of a character which is subject to depreciation pursuant to *IRC § 167*
☐

(3) Held for more than six months; and ☐

(4) Not inventory or property held primarily for *sale* to customers in a trade or business
[*IRC § 1231(b)*]..... ☐

b. If a patent is used in a trade or business or held for the production of income, it is considered as an intangible asset, the cost or basis of which must be depreciated over its remaining useful life [Reg §§ 1.167(a)-3, 1.167(a)-6(a)]..... ☐

2. If, during the taxable year, gain recognized from the sale or exchange of patents exceeds losses recognized from such sales or exchanges, the difference is considered long-term capital gain [*IRC § 1231(a)*] ☐

D. Research and experimental expenditures ☐

1. Definition of research and experimental expenditures ☐

a. "Research and experimental expenditures" are those which: ☐

(1) Are incurred in connection with the taxpayer's trade or business; and.....
☐

(2) Represent research and development costs in the experimental or laboratory sense
[Reg § 1.174-2(a)(1)]..... ☐

b. The following are examples of expenditures which come within the above definition [Reg § 1.174-2(a)(1)]:..... ☐

(1) All costs incidental to the development of: ☐

(a) An experimental or pilot model ☐

(b) A plant process..... ☐

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(c) A product..... ☐

(d) A formula..... ☐

(e) An invention of similar property; or ☐

(f) An improvement of any of the above ☐

(2) Costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application..... ☐

c. The following are examples of expenditures which do not come within the above definition:..... ☐

(1) Testing or inspection of materials or products for quality control..... ☐

(2) Surveys..... ☐

(3) Management studies..... ☐

(4) Consumer surveys..... ☐

(5) Advertising or promotion..... ☐

(6) Acquiring another's patent, model, production, or process ☐

d. The expenditures may relate either to a general research program or to a particular project [Reg § 1.174-1]..... ☐

2. Deduction or amortization of expenditures ☐

a. A taxpayer may elect either of the following procedures with respect to allowable expenditures:..... ☐

(1) To deduct the full amount of such expenditures as a current expense in the year paid or incurred [*IRC § 174(a)*; Reg § 1.174-3]..... ☐

or

(2) To treat such expenditures as deferred expenses, deductible ratably over a period selected by the taxpayer, but not less than 60 months, commencing with the month in which benefits are first realized [*IRC § 174(b)*; Reg § 1.174-4(a)(3)] ☐

b. Post-1986 research and experimentation expenses are not deductible expenditures for alternative minimum tax purposes. Instead, in computing alternative minimum tax income, individual taxpayers are required to amortize the expenditures ratably over a ten-year period [*IRC* §§ 56(b)(2), 59(e)] ☐