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Taxation of Computer Software Sales: Ordinary Income, Capital Gain, or Both?

BY DAVID C. BLUM

The taxation of computer software is complex, confusing, and in some circumstances, uncertain; although self-created computer software is routinely sold today, especially with the significant increase in the number of ''apps'' that are created for mobile devices, there is surprisingly little statutory or regulatory guidance on the proper way to tax the sale of such software.

In general, the taxation of software can vary greatly depending upon a multitude of factors, including, for example, whether the software was acquired or developed, and if developed, whether it was developed for internal use or developed for sale in the ordinary course of business, as well as whether the software was sold or licensed.[1] This article focuses on the tax aspects of the sale of computer software and related intellectual property by the person whose personal efforts created such IP rights.

As a first step, the software must be sold and not merely licensed. In order to ''sell'' software, the transferor must transfer all or ''substantially all'' rights to the software. This typically occurs when the transferor transfers both the source code and the object code without restriction.[2]

Because computer software may be protected under various intellectual property rights, several Internal Revenue Code (the Code)[3] provisions are potentially applicable in characterizing the gain or loss recognized on the sale of computer software. However, IP rights, such as copyrights, trademarks, trade secrets, patents and know-how, are all generally subject to different provisions of the Code and common law. As a result, they are all generally taxed differently, and therein lies the problem. Some of these provisions have directly contrasting taxing schemes and the application of these various provisions result in differing federal income tax treatment.

Further, there is little statutory or regulatory guidance to indicate which Code provisions control when an asset such as ''software'' is capable of being protected under both copyright and patent laws. For example, should copyright tax provisions trump patent tax provisions or vice versa? The answer is unclear.

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The Tax Court addressed the sale of software more than 20 years ago in *Levy v. Commissioner*.[4] That case however focused solely on the sale of software as a single asset and did not address each of the IP rights that comprised the software and related IP. Until more guidance is available, practitioners should determine what specific assets were sold (assigned), rather than rely solely on a single case that does not fully address the realities of today.

What Assets Were Really Sold?

A software purchase agreement may contain language such as, ''The Seller/Assignor agrees to sell/assign all of its right, title, and interest throughout the world in and to the Software Products and all intellectual property embodied in the Software Products, including, but not limited to'':

- all patent rights, if any;

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[1] For a good overall discussion of the taxation of software, see Postlewaite, Cameron & Kittle-Kamp, *Federal Income Taxation of Intellectual Properties and Intangible Assets*.

[2] Note, Treasury regulations under Section 861 also address the sale versus license distinction for software in the context of sourcing of income for cross-border tax purposes.

[3] All references to the ''Code'' are to the Internal Revenue Code of 1986, as amended, and any Treasury Regulations promulgated thereunder.

[4] T.C. Memo 1992-471.

- all copyrights;
- all rights of paternity, integrity, disclosure, and withdrawal, referred to as ''moral rights'';
- all trademark rights, including all trademarks, service marks, trade names, domain names, logos and trade dress, any common law rights, and goodwill associated therewith;
- all computer code embodied in the software products;
- all trade secrets, know-how, technology, and other confidential business information embodied in the software products;
- all notes, manuals, analysis, compilations, studies, summaries, and other material prepared by or for the seller/assignor to the extent relevant or necessary to those items above; and
- all rights and privileges pertaining to the subject matter of the items above.

The seller/assignor may also typically assign, transfer, sell, and convey to the buyer/assignee ''such methods, tools, techniques, logic, and know-how used by Seller/Assignor to create the Software Products.''

Thus, the seller/assignor will generally sell all of its interests in or to various IP rights (to the extent such were in existence) to the buyer/assignee. With respect to the specific assets, one must consider, among other things, whether registered or unregistered copyrights were assigned; whether any patent or patentable rights were assigned; whether any trademarks, service marks, or trade names were assigned, as well as whether there was an assignment of trade secrets, know-how, technology, and other confidential business information embodied in the software products.

Taxation of Intellectual Property

Copyrights

Section 1221(a) of the Code defines a ''capital asset,'' in relevant part, as all assets other than:

- inventory held primarily for sale to customers in the ordinary course of business;
- property used in a trade or business subject to depreciation provided for in Section 167; and
- a copyright, literary, musical, or artistic composition, or ''similar property'' held by the person whose personal efforts created such property.

Thus, if a person sells a copyright that he or she created, then it cannot generally qualify as a capital asset, and as a result, cannot be taxed at capital gain tax rates. Instead, it would be taxed at ordinary income tax rates.

The legislative intent behind this exclusion is to prevent the creator of a work protected under copyright laws from converting what would otherwise be compensation for personal services (taxed as ordinary income) into property taxed at capital gain rates. However, as discussed below in the section on patents, the exact opposite is true.

Because computer software is typically protected under copyright law (whether or not registered), Code Section 1221 is generally applicable to the sale of computer software. The Tax Court directly addressed the federal income tax treatment of the sale of computer software code in *Levy*.

In this case, the taxpayer (a computer programmer) was denied capital gain treatment on the sale of computer software. The court concluded that, because the software was eligible for copyright protection, the exclusion contained in Section 1221(a)(3) applied. Thus, the sale of software was taxable at ordinary income (and not capital gain) tax rates. The fact that the taxpayer did not seek copyright protection was deemed irrelevant.

In *Levy*, the taxpayer entered into an agreement to sell ''all rights and interest in and to the Systems, including without limitation, all source and object code and manuals and all other related documentation and materials therefor and all enhancements now existing or hereafter made thereto.'' The Tax Court considered the characterization of the gain recognized on the sale and after examining copyright law and its protection of computer software, the court applied the literal language of the Code and regulations and concluded that the software's eligibility for protection under the copyright law brought it within the exclusion under Section 1221(a)(3).

In *Levy*, the court concluded that the software's eligibility for protection under the copyright law brought it within the exclusion under Section 1221(a)(3).

Notably, the taxpayer did not appear to argue, nor did the court address, whether the self-created software could have also been covered by patent, trade secret, know-how, or any other IP protection. Consequently, the decision did not address the applicability of other possible IP being sold along with the unregistered copyrights.

Patents

In direct contrast to copyrights, Section 1235 of the Code provides that the transfer of property consisting of ''all substantial rights'' to a patent by any holder shall be considered the sale or exchange of a capital asset held for more than one year. Therefore, a holder would generally qualify for long-term capital gain tax rates regardless of the holding period.

A ''holder'' of a patent is statutorily defined to include ''any individual whose efforts created such property.'' Under Section 1235, it is not necessary that the patent or the patent application be in existence if the requirements of Section 1235 are otherwise met.[6]

As a result, if computer software (or some portion thereof) is patentable, an argument exists that the taxpayer may be able to claim the benefits of Section 1235 on the sale of such software. One case, *Gilson v. Commissioner*,[7] appeared to take such a view.

In *Gilson*, the taxpayer was a professional inventor of industrial designs. He operated his business as a sole

[6] Treas. Reg. Section 1.1235-2(a).

[7] T.C. Memo. 1984-447 (Aug. 21, 1984).

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proprietorship, and his clients hired him to undertake the industrial design of a new product the client had developed and hoped to manufacture and market.

The taxpayer (Gilson) took the position on his tax return that he created and sold designs capable of being patented and thus qualified for capital gain treatment under Section 1235. The Internal Revenue Service disagreed and took the position that he was merely compensated for his services (i.e., "hired to invent"), and thus his fees should be taxable as ordinary income.

The court ultimately held that Gilson was entitled to capital gain treatment on payments received (as an industrial designer) from his clients. The payments were consideration for the transfer of the designer's rights to patentable designs.

Similar to *Levy*, the Tax Court only focused on one type of intellectual property right. It is notable that the industrial designs in this case should have also been protected under copyright law. Unfortunately however, the case did not discuss copyright protection and more importantly, did not discuss which right controls and whether or not there could be some form of allocation between the two.

Commenters have pointed to this case to speculate whether this decision could support the notion that the sale of patentable software, though also copyrightable, could fall under Section 1235, enabling capital gain treatment for at least a portion of the assets sold.

Know-How

The term "know-how" is not defined in either the Code or the regulations. However, IRS has described know-how in several revenue rulings and revenue procedures.

One such ruling states that know-how includes "secret processes and formulas" as well as "any other secret information as to a device, process, etc., in the general nature of a patentable invention without regard to whether a patent has been applied for . . . and without regard to whether it is patentable in the patent law sense."[8] IRS has also stated that know-how "represents a discovery and, while not necessarily patentable, the 'information' is original, unique and novel."[9] Secrecy of the know-how is a critical component.

Because no special Code provision has been enacted for the purpose of determining the type of income recognized by the transfer of know-how, the tax consequences are determined entirely under general tax principles and common law. The courts and IRS have sometimes applied the principles of Section 1235 and the regulations thereunder by analogy since certain know-how can be in the general nature of a patentable invention. To the extent that know-how used in a trade or business is considered "property" (and not services), it will generally be subject to capital gain treatment, provided the transferor sells all substantial rights to the know-how.

Trade Secrets

Trade secrets are also generally treated as property and therefore capable of being sold at capital gain rates. A trade secret is generally considered to be any information, including an unpatented invention, a formula, pattern, compilation, device, machine, process, customer list, or even news that:

- derives independent economic value (actual or potential) from not being generally known to the public or to other persons who could obtain economic value from its disclosure or use; and
- is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.[10]

In other words, a trade secret is any information not generally known. As long as it is a secret, it is valuable, as it provides an advantage over competitors. A trade secret's underlying information is frequently in the public domain; thus, it is not the information that must be secret but rather the way in which the information is used.

Like know-how, there is no specific Code provision to determine the type of income to be recognized by the transfer of a trade secret. However, the courts and IRS have relied upon both general tax principles and Section 1235 by analogy. To be eligible for capital gain treatment, the transferor must also transfer all substantial rights to the trade secret.[11]

What Is the Tax Characterization?

Not only is there scant authority to address the taxation of software capable of being protected under both copyright and patent law, but to rely solely on *Levy* to determine the characterization of the gain on the sale of computer software is also potentially misleading.

The sale of assets comprising software products can generally be analyzed from two different perspectives:

- per *Levy*—as a sale of "computer software" and related IP; or
- as a sale of specific assets (i.e., the sale of a copyright and other IP assets embodied in or related to the software as delineated in a purchase agreement).

Regardless of how this is analyzed however, the answer should be the same for federal income tax purposes, as explained below.

Sale of 'Computer Software' And Related IP Approach

Taking *Levy* into consideration, if the transaction were viewed as a sale of computer software and related IP, the threshold questions would be what exactly was sold and how do you allocate purchase price, if at all, between the assets.

If the tax analysis was viewed as just the sale of software, the Tax Court in *Levy*, as discussed above, explicitly held that the sale of computer software by the creator of the software was a taxable sale of a copyright. Because copyrights are not capital assets by statute, the sale was held to be taxable at ordinary income tax rates.

The court did not address, and the taxpayer did not appear to argue, that any other IP rights were sold (e.g., trade secret, know-how, or patent rights). Consequently, the taxpayer was left with the sale of an unregistered copyright. It is unclear how IRS or a court would

[8] Rev. Rul. 64-56, 1964-1 C.B. 133, *amplified by* Rev. Rul. 71-564, 1971-2 C.B. 179.

[9] Rev. Proc. 69-19, *amplified by* Rev. Proc. 74-36, 1974-2 C.B. 491.

[10] *DuPont v. United States*, 288 F.2d 904 (Ct. Cl. 1961).

[11] Rev. Rul. 64-56, 1964-1 C.B. 133, *amplified by* Rev. Rul. 71-564, 1971-2 C.B. 179.

rule if the sale of multiple IP rights were raised and argued by the taxpayer.

In *Gilson* (discussed above), the taxpayer sold industrial designs that were generally subject to both patent rights and copyrights. The Tax Court in that case only focused on the patent aspect of the designs (even though patents were not generally applied for) to conclude that the taxpayer was subject to the favorable capital gain rates. The court did not address the fact that the designs could have also been treated as a sale of unregistered copyrights, thus leaving open the question of what to do when the same asset is capable of being subject to multiple IP rights.

In this case, consideration should be given to what rights the seller/assignor possessed by looking at it from an infringement standpoint. That is to say, if the software embodied IP rights in addition to copyrights, and if there were an infringement, could the seller/assignor have argued, for example, a misappropriation of trade secrets, know-how, and/or other IP rights? If the seller/assignor could have alleged more than just copyright infringement when he or she owned the software, then the seller must have also held such other IP rights, which were capable of being sold to the buyer/assignee.

Therefore, if one were to adopt *Levy*'s ''sale of software'' approach, one must also consider the sale of all the assets, namely, copyrights (per case law) and any other assets (e.g., patents, trade secrets, and know-how). One objective measure is to look to what other rights could have been protected from infringement. If the seller transferred rights that were capable of being protected from infringement (other than copyrights), then practitioners can apply *Levy* with respect to the copyright aspects of the software and also apply general tax principles with respect to the ''other IP'' transferred.

Sale of Specific Assets Approach

If instead of looking at this transaction from a sale of software perspective (per *Levy*), one looks at this from a technical asset transfer perspective, the seller/assignor should get to the same result. The sample purchase agreement mentioned above sets forth a list of IP assets that are typically assigned, including patents; copyrights; all computer code embodied in the software products; all trade secrets, know-how, technology, and other confidential business information embodied in the software products; all notes, analysis, compilations, studies, summaries, and other material prepared by or for the seller/assignor to the extent relevant or necessary; all rights and privileges pertaining thereto; and such methods, tools techniques, logic, and know-how used by the seller/assignor to create the software products.

Consistent with the purchase agreement (and arguably the better way to view this transaction) is to view it not as a sale of software, but rather as a sale of a collection of IP rights that constitute the entirety of a collective asset (e.g., an app) or the entirety of a software business. In analyzing the above sample purchase agreement, the seller/assignor likely sold unregistered copyrights and likely also sold certain capital assets, such as assets capable of being patented, trademarks, trade secrets, know-how, and other confidential business information embodied in the software products.

It is advisable in this circumstance that the parties retain an independent IP expert or valuation expert to identify and value each such asset. An allocation of the purchase price can then be made based on the relative fair market value of each asset. Finally, a determination could be made as to whether each asset is subject to ordinary income or capital gain treatment and what, if any, recapture needs to be taken into account.

Conclusion

The characterization of gain or loss realized and recognized on the assets sold pursuant to a software purchase agreement will depend on the type of asset involved and the manner in which it was created. Regardless of whether this is viewed as a sale of computer software with related IP or a sale of IP rights that constitutes the entirety of a software business, the seller/assignor should get to the same result, recognizing that it is not clear what to do for tax purposes when an asset is capable of being protected under both copyright and patent.

The transaction must be evaluated based upon the sale of each of the assets transferred, and if something other than copyrights were transferred, there should be a reasonable allocation of the purchase price between each of the assets based on fair market value at the time of sale. It is therefore recommend that an independent third-party IP valuation expert be engaged to determine each of the IP assets that were sold and the relative fair market value of each such asset.

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