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Patent Turmoil: Self-Created IP After Tax Reform

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The "Tax Cuts and Jobs Act of 2017" (the "TCJA") impact on the tax treatment of self-created intellectual property ("IP") is resulting in a wide range of feelings depending on the nature of a particular party's IP. Contrast the howls of outrage from inventors, their investors and the technology sector in general over those provisions of the "TCJA" impacting the tax treatment of self-created IP with the loud sighs of relief from Nashville, Los Angeles, Austin and other centers of the music industry that the TCJA does not impose on them the same changes.

The source of the frustration for some and relief for others is the statement in the Joint Explanatory Statement of the Committee of Conference that the changes set forth in Section 3311 of the House Bill are intended to ensure that "gains or losses from the *sale of a patent, invention, model or design (whether or not patented), or a secret formula or process [collectively "Property"]...*held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the [creating] taxpayer (or for whom the property was created) <u>will not receive capital gain treatment</u> (emphasis added)."

Prior Law

An understanding of the pre-TCJA law is important in order to appreciate how the sale of self-created Property is to be treated by the TCJA. That analysis begins with IRC Section 1221(a), which defines "capital assets" to mean property held by the taxpayer unless specifically listed as an exception elsewhere. Pre-2018 Section 1221(a)(3) expressly excluded self-created copyrights, literary, musical or artistic compositions or similar property from the definition of a capital asset (in addition to separate paragraphs excluding inventory, as well as depreciable and real property, as examples). Prior law never expressly discussed self-created IP. Accordingly, such assets were characterized as "capital assets."

Two other provisions of pre-2018 tax law also are important in this analysis. First, IRC Section 1221(b)(3) which allows taxpayers who create musical compositions or copyrights in musical works (as well as those whose basis in such property is determined by the basis of the property's creator) an election to treat the sale or exchange of such self-created music property as the sale or exchange of a capital asset(s). Accordingly while technically not capital assets, the sale of such self-created musical intellectual property receives favored tax treatment pursuant to a specific provision of the tax law. Second, the stand-alone provisions of IRC Section 1235 allow the transfer of "all substantial rights" to a patent by the creator (an individual) and/or an investor (again, an individual) who acquired an interest in the patent prior to "the actual reduction to practice of the invention covered by the patent" to receive capital gain treatment. This favored tax treatment applies when payment is either (i) payable periodically and associated with the transferee's use of the patent, or (ii) contingent upon

use or productivity of the patent. For purposes of Section 1235 it is important to note that transfers for money or money's worth between the creator and the creator's employer or persons described as related to the creator under Section 267(c) (related parties sales) or Section 707(b) (controlled partnerships) (with certain percentage ownership ratio adjustments mandated by Section 1235) generally prevent the sale to a third-party by such related parties from qualifying for capital gain treatment. While Section 1235 applies solely to individuals (e.g., only individuals can be "holders"), the IRS has long acknowledged that the partners of a partnership can qualify for capital gain treatment because they are to be treated as the "holders" of their pro rata share of a patent sold by the partnership in a manner which resembles one of the financial arrangements described in the statute (See Treas. Regulation Section 1.1235-2).

Additionally IRC Section 1231 defines "property used in a trade or business," and specifically excludes copyrights, literary, musical or artistic compositions, "or similar property held by a taxpayer [and] described in paragraph (3) of Section 1221(a) [the capital asset definitions]." This provision is important in post-TCJA planning discussions because gain in excess of any recaptured depreciation or amortization typically was eligible for capital gain treatment.

What Happens To Self-Created IP Under TCJA?

The actual language of Section 3311 of the TCJA provides only that Code Section 1221(a)(3) is amended to add the following language, "a patent, invention, model or design (whether or not patented), a secret formula or process," in front of the current list of items of property which are not capital in nature; specifically copyrights, literary, musical or artistic compositions and other self-created property. A conforming amendment for Code Section 1231(b)(1)'s list of property not qualifying as "property used in a trade or business" follows the first amendment. Therefore, patents, inventions, models or designs and secret formulas or processes no longer qualify as capital assets, nor do they qualify as property used in a trade or business. As written, this last provision, absent a fix via technical corrections legislation or regulation, appears to apply to <u>any</u> taxpayer who owns and has depreciated a patent, etc. Likely this means that after recapture, all gain remains ordinary.

On a positive note, or at least until technical corrections are proposed, Congress retained the narrow exception provided by Section 1235 which allows some inventors and investors the opportunity to obtain capital gain treatment when transferring "all substantial rights" to a patent. Unfortunately, Section 1235 does not apply to self-created non-patent property; e.g., inventions, models or designs (unpatented), or secret formulas or processes - it only applies to patents.

For those in the music industry the good news is that the limitation on capital gain treatment of selfcreated IP does not apply to self-created copyrights, literary, musical, or artistic compositions and similar property. The IRC Section 1221(b)(3) election remains unchanged by the new law.

Self-Created IP Tax Planning Post Tax Reform

In order for individual inventors, or their investors in start-up companies (presuming said companies are partnerships for tax purposes), to position themselves to obtain benefits from Code Section 1235, consideration must be given to whether to transfer at some point in the future "all of the substantial rights" in one or more patents owned by or being developed by the inventor and whether such a transfer is acceptable from a business standpoint (e.g., as part of the long-term business plan of the individual inventor and the investors).

There are other planning strategies that inventors and their partners should consider. First, sell the ownership of the company and not its assets. This is not impossible, but is difficult to accomplish with the tax exposure likely to impact the price point negotiations. Inventors looking to plan their exit strategy should identify all aspects of the business which have or may later have value and take the legal steps necessary to separate and document such aspects for easy recognition as separate assets. Goodwill, workforce-in-place, trademarks, customer-based intangibles, even supplier intangibles, may have value. If the exit transaction is a sale of all of the assets, assuming all intangibles are specifically identified in the sales documents along with any self-created IP, those other assets should still generate capital gain. Bottom line, identify capital gain assets now and take all steps required to ensure their recognition in a sale.

The IP Industry Verdict

Overall, it appears that the new law poorly treats owners of and investors in self-created IP. As always, the usual caveat applies to our discussion of tax reform's impact on self-created IP; each taxpayer should consult with his/her own tax advisor or professional in order to make sure that the inventor and the investors properly understand these new rules and appropriately analyze the unique circumstances of each, especially when evaluating what might be the most tax effective legal structure for them.

If you would like more information on the self-created IP tax changes identified above, to discuss the application of any of the concepts to you or your inventions, or if you want more information on any other tax or IP legal matter, please feel free to contact any of the following tax or IP lawyers directly:

Burr's Tax Team:

- Ed Brown and/or Jim McCarten in Atlanta at (404) 815-3000;
- Jim McCarten, Josh Ehrenfeld, Tucker Herndon or Maureen Beaver in Nashville at (615) 724-3200;
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- Joe Letzer, Ellen Mathews, Elizabeth Shirley and India Vincent in Birmingham at (205) 251-3000;
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- <u>Greg Lunny</u> in Jacksonville at (904) 232-7200;
- <u>Bradley Vance</u> in Jackson at (601) 355-3434.

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