Taxation of exempts

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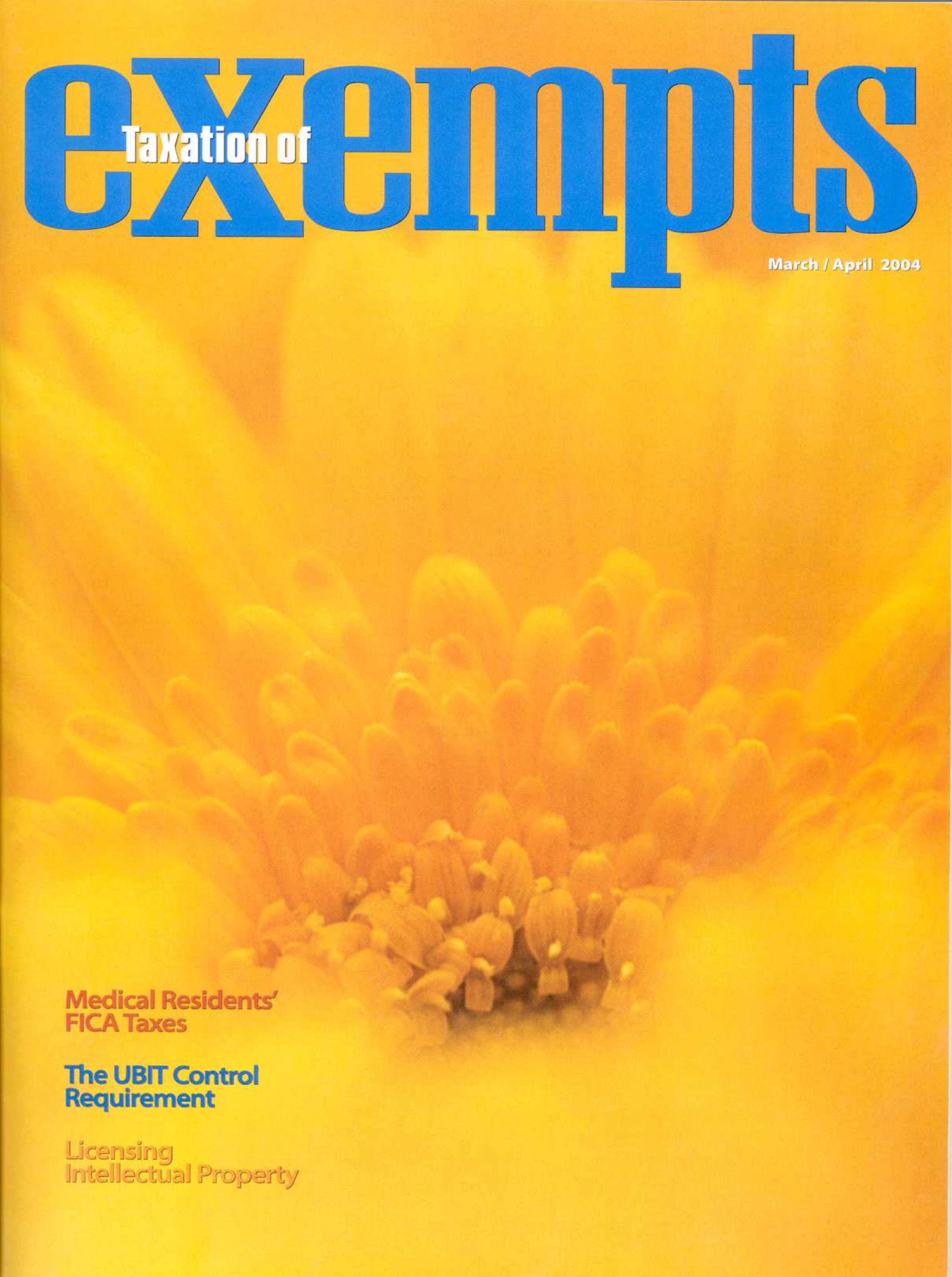

Medical Residents' FICA Taxes

The UBIT Control Requirement

Licensing Intellectual Property

THE TAXATION AND REPORTING OF DISTRIBUTIONS DERIVED FROM LICENSING INTELLECTUAL PROPERTY

Recent tax developments may put cash into the pockets of the researchers.

EDWARD J. JENNINGS

The Job and Growth Tax Relief Reconciliation Act of 2003 grants additional tax benefits to those individuals who qualify for the preferred capital gains treatment. It lowers the capital gains tax rate on most long-term capital assets for individuals from 20% to 15%, effective for sales and exchanges after 5/5/03 through 2008.[1] Certain distributions made to individuals that are derived from the commercialization of technology may qualify for capital gains treatment. To bolster good relations, educational institutions and nonprofit entities that license intellectual property may inform their researchers of these benefits.

The body of tax law regarding capital gains treatment for licensed technology presents a labyrinth of distinctions and requirements in a haze of ambiguities and uncertainties. Although patents, copyrights, and know-how properties[2] may receive capital gain treatment, different requirements apply to each type of property with certain key definitions and terms in debate. The discussion below will employ a traditional analytical framework to determine the tax consequences of these distributions,[3] and will center on a standardized and consistent method to report these transactions as a means to assuage the concerns of all interested parties. See also the flow chart in Exhibit 1 on page 210.

Introduction

The fundamental issue is whether the distributions made to the researcher constitute compensation for services rendered or represent income from the transfer of intellectual property. As a subsidiary issue, income derived

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ALTHOUGH PATENTS, COPYRIGHTS, AND KNOW-HOW PROPERTIES ALL MAY RECEIVE CAPITAL GAIN TREATMENT, DIFFERENT REQUIREMENTS APPLY TO EACH TYPE OF PROPERTY.

from technology transfers is classified either as royalty income or as capital gains from sales of short or long-term capital assets. Important tax consequences turn on these classifications. Those distributions classified as compensation are treated as earned income subject to FICA or self-employment taxes in addition to ordinary income taxes. Distributions classified as royalties and as gains from the sales of short-term capital assets are subject to ordinary income taxes with only those gains from the sales of long-term capital assets entitled to the capital gains taxes. The capital gains tax rates for individual taxpayers can, on average, be approximately 20% lower than the ordinary income tax rates.

The application of capital gains treatment varies by the type of property transferred and the applicable tax law. For instance, under Section 1235 (hereinafter referred to as the "patent provision"), those distributions relating to patents are treated as capital gains when all of the substantial rights of the property are transferred to unrelated parties. Alternatively, should the patent fail to meet the requirements of the patent provision, it may qualify for capital gains treatment under Section 1221 or Section 1231 (hereinafter referred to collectively as the "capital asset provisions").[4]

Sales of patents, certain copyrights, and know-how property may qualify for capital gains treatment under the capital asset provisions when the property is (1) transferred in its entirety, (2) not held primarily for sale to customers in the ordinary course of trade or business, and (3) held for more than one year. This provision precludes capital gains treatment to copyrights when the holder is the creator of the property,[5] and limits application to know-how that is considered secret information—i.e., secret processes or secret formulae.[6]

Non-secret know-how may meet the requirements of the patent or capital asset provisions when the property is in the form of services and these services are ancillary to the transfer of intellectual property.[7] Otherwise, non-secret know-how is generally not considered to be intellectual property and any payments made in relation to it are treated as compensation.

In consequence, it is the responsibility of the research institution to navigate the complexities of each transfer to report properly the distributions as taxable income.

The Code requires that distributions classified as compensation paid to an employee be reported as wages on Form W-2, "Wage and Tax Statement," and that such distributions paid to an independent contractor be included as non-employee compensation on Form 1099-Misc, "Miscellaneous Income." The Code provides no reporting requirements per se for capital gains distributions from intellectual property.[8]

This conventional method of reporting, however, may not best meet the concerns and interests of the institutions and their researchers. Institutions bear a tax risk for improperly reporting taxable income should they misclassify these distributions. In particular, improper reporting may impact private institutions and affiliates of state agencies that are subject to the intermediate sanctions provision. Also, improperly reporting taxable income for its researchers may jeopardize the institution's relationship with its researchers, possibly threatening the continued success of its technology transfer program. Further, the administrative costs incurred to properly classify the transfer of each property may be prohibitive, based on the institution's presumed duty to minimize financial burdens. Thus, the principles of practicality and prudence rec-

[1] For individuals in the low-income tax bracket, the Act reduced the capital gains tax rate from 10% to 5% effective for sales and exchanges after 5/5/03 through 2007. In tax year 2008, the 5% rate drops to 0%, then returns to 10% in 2009. This tax benefit is not available to corporations subject to Chapter C of the Code.

[2] The tax consequences relating to trademarks, service marks, trade names, and franchises are beyond the scope of this article.

[3] See generally Harding, *The Tax Law of Colleges and Universities* (John Wiley & Sons, 2001); 557 Tax Management Portfolio, "Planning for the Development and Licensing of Patents and Know-How" 1995-2002; 558 Tax Management Portfolio, "Planning for the Development and Licensing of Copyrights and Software" 1995-2002.

[4] Reg. 1.1235-1(b); Rev. Rul. 69-482, 1969-2 CB 164.

[5] Reg. 1.1221-1(c)(1) and Reg. 1.1221-1(c)(2).

[6] Rev. Rul. 55-17, 1955-1 CB 388, *mod. by* Rev. Rul. 64-56, 1964-1 (Part 1) CB 133, *amplified by* Rev. Rul. 71-564, 1971-1971-2 CB 179; Wall Products, 11 TC 51 (1948), acq., 1949-1 CB 4; U.S. Mineral Products, 52 TC 177 (1969); DuPont, 7 AFTR 2d 1107, 289 F2d 904 (Ct. Cl., 1961).

[7] Rev. Rul. 64-56, *supra* note 6; Gilson, TCM 1984-447; Gable, TCM 1974-312; Hooker Chemicals and Plastics Corporation, 591 F.2d 652, 43 AFTR2d 79-573 (Ct. Cl., 1979); DuPont, *supra* at note 6.

[8] Section 6041, which requires Form 1099-Misc to be filed, excludes by implication sales of capital assets. Section 6045, which requires Form 1099-B to be filed, does not define research institutions as brokers.

ommend that institutions adopt a simplistic approach promoting a standardized and consistent method of reporting that meets the filing standards of the IRS yet satisfies the interests of the technology community.

Compensation for services or income from transfer of intellectual property

The income characterization of distributions made to researchers as either compensation or as income from transferred technology turns on the type of property in question and the status of the inventor.

Patents and know-how. The courts have analyzed the taxation of patents invented by employees by whether there is a transfer of the property and, if so, whether the payments made to the employee attach or relate to that property. The reasoning is that without property to transfer, or with transferred property but no consideration attributed to it, the distributions constitute compensation for services rendered. The analysis for independent contractors with respect to patent and secret know-how property is merely whether those distributions were made in relation to the transfer of the property.[9]

Hired-to-invent. When interpreting the regulations on patents, the courts have applied a "hired-to-invent" principle to determine whether an employee transferred property. Reg. 1.1235-2(a) expressly provides "that payments received by an employee for services rendered as an employee to transfer to the employer the rights to any invention by such employee are not attributable to a transfer to which section 1235 applies." If the employee was hired-to-invent a specific product as part of the employment agreement, the payments are classified as compensation because the consideration is "for his labor, not for the product" whereby, the "invention" is the "property of his employer."[10] As a point of distinction, the courts recognize that the initial ownership of property rights vests with the employees, permitting employees to transfer property. Thus, assignment agreements standing alone are not sufficient to divest the employees of ownership.[11] These agreements are commonplace between employees and employers within the technology community under which, as a condition of employment, any and all inventions made by the employee become the sole property of the employer.[12]

The court cases provide guidance as to the use of the term "hired-to-invent" based on a detailed review of the facts and circumstances of each arrangement. In *Blum*,[13] the employer hired the taxpayer for the specific purpose of making adaptations to a particular chain saw that the company intended to sell. While performing his responsibilities, the taxpayer made certain inventions regarding the chain saw and, based on the employment agreement, these inventions became the property of the company. In reading the terms of the contract, the court held that the taxpayer entered into a "contract to invent" and that the employer owned the property outright. Thus, without the transfer of property, the payments made to the taxpayer were compensation for services rendered.

The court in *McClain*, however, held that the inventor was not hired-to-invent. McClain, who had entered in an "assignment of inventions agreement" as a condition of employment, invented two patents while working at Lockheed where he was assigned as a layout draftsman to design window installations for the cockpit section of the fuselage of the Model 44 aircraft. He conceived and invented a new and different windshield construction to be used on the aircraft, a polymerized vinyl butyral for use between the windshield glass. It was anticipated by Lockheed that McClain would use the existing state of the arts materials and techniques to perform his duties. The court found that the employee was clearly not hired-to-invent and that the patented property did transfer.

The court in *Chilton* gives a more likely scenario in the sense that the employee was hired to render "engineering work relating to the improvements of existing types of aircraft

[9] Gilson, *supra* note 7.

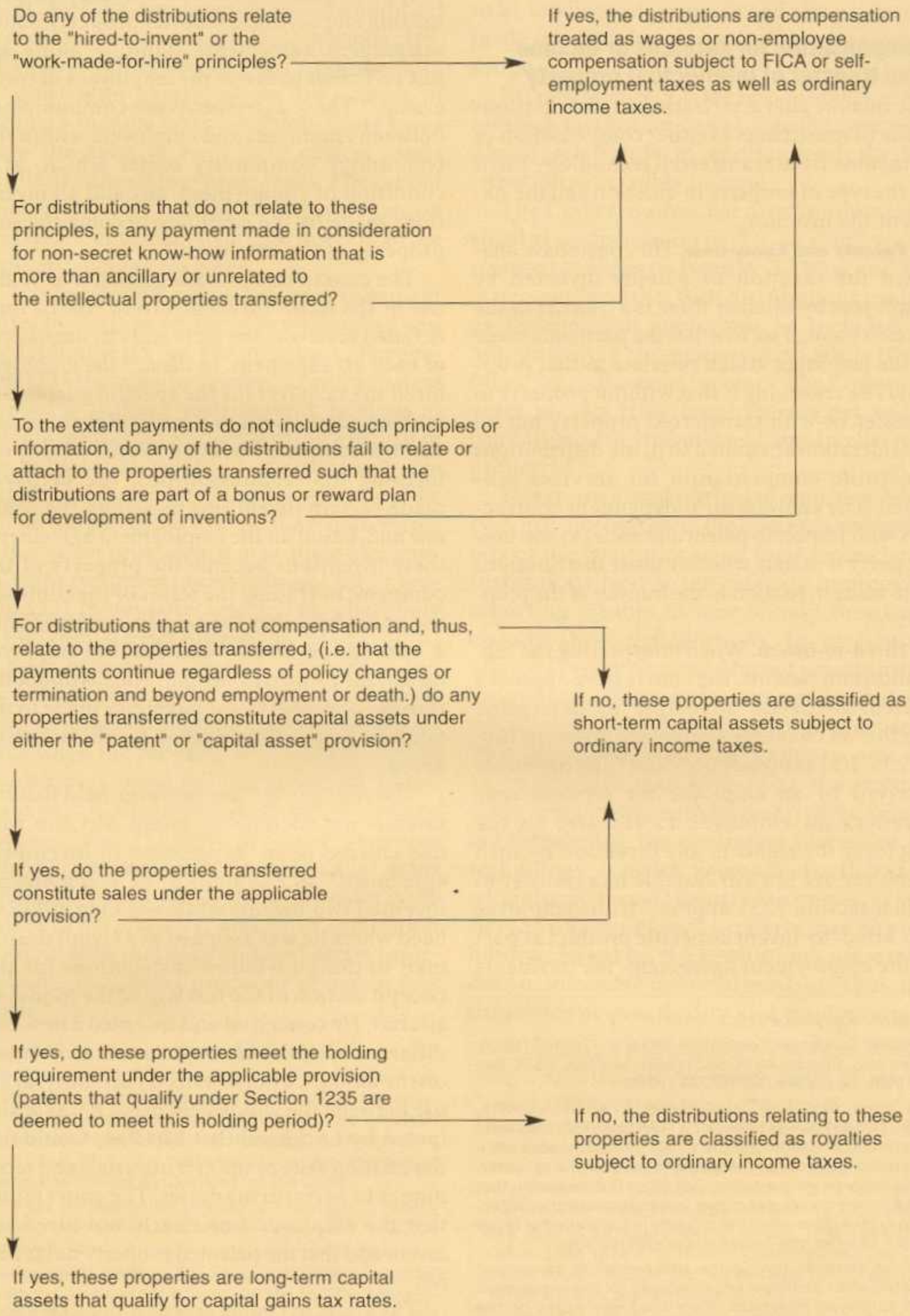
[10] Dubilier Condenser Corporation, 289 U.S. 178, 187 (1933); See also, Chilton, 40 TC 552 (1963); McClain, 40 TC 841 (1963); Beausoleil, 66 TC 244 (1976).

[11] In Gilson, *supra* note 7 and Lehman, 61 AFTR 2d 88-345, 835 F.2d 431 (CA-2, 1987), *aff'g* TCM 1987-158, the courts note that that although the assignment contracts were entered into prior to the actual transfer of the property, the consideration attaches based on the reasoning that the contracts are executory in nature and either effectively take place when the property is transferred or relate back to when the contract was entered into.

[12] Under common law, in the absence of an agreement between an employer and employee for the assignment of employee inventions, if an employee works on the patent during the scope of employment, the employer is entitled to "shop rights," which grant the employer a non-exclusive right to use the employee's invention.

[13] 11 TC 101 (1948).

EXHIBIT I. Flowchart on the Taxation of Distributions Paid to Researchers when Licensing Intellectual Property.



engines" as well as to "apply his experience and his inventive ability to problems." He entered into an assignment arrangement whereby the employer owned the rights to any inventions until after 90 days from the date of completion of the development tests. Thereupon, if the employer did not pursue developing the technology, the employee was free to apply for a patent on this invention for himself. Based on a close examination of the facts, the court held that the employee was clearly not hired-to-invent.

Bona fide transfers. If it is determined that the employee was not hired-to-invent, the courts examine the facts and circumstances of the agreement, relying on certain factors to indicate a bona fide transfer of property rights. These factors include a legally binding agreement to make a fixed payment amount that continues regardless of termination or changes in policy and after employment or death. Also, the payments should be dependent on the use of the invention.[14] The rationale is that the payment stream is beyond the discretion and control of the employer to attribute compensation. The courts use these same factors for distributions made to independent contractors.

The courts in *McClain* and *Chilton* addressed the issue of whether consideration attached to the transferred patents. In *McClain*, the employer implemented a plan to reward employees for "original thinking" and paid the employees 10% of the money received from licensing or sale. The royalties were not to be affected by changes in or discontinuance of the plan, the employee was to receive his share in revenues whether or not he remained with the company and, in the event of death, his heirs would receive the continuing payments. The court held that the distributions were attributed to the patent rights and constituted a royalty entitled to capital gains treatment under the patent provision. The *Chilton* court held likewise because the employee was to receive a percentage of the patent revenues and the royalties were to continue during the life of the patent.

In contrast, the *Lehman* court found that the $30,000 award paid to an employee constituted compensation for services rendered. Although the employee was not hired-to-invent, the court determined that the payments were not connected to the transfer of the property. The award plan was similar to a bonus arrangement to recognize achievements. Also, the fact that the stipend was paid 16 years after the employee assigned the patent gave evidence that the payment was not based on use of the transferred property.[15] The court in *Beausoleil* held that an award of $1,600 paid under an invention achievement award was compensation for services rendered since the payment bore no relationship to the economic value of the inventions.[16]

The IRS recently released TAM 200249002, which agrees with the analysis put forth by the courts.[17] The facts pertain to a university setting in which a professor at a state university who performs multiple tasks of teaching, conducting research, and various administrative tasks, with research efforts varying anywhere between 50% to 100% in any given academic term, agreed to transfer rights of future inventions in his employment contract. It is university policy to assess the value of the property transferred and, if the school chooses to commercialize the invention, it will pay royalties to the researcher based on the use of the property. Should the institution elect not to exercise the property rights, however, the invention is returned to the employee to do with as he or she sees fit. This TAM concludes that the property transferred constitutes a royalty that was entitled to capital gain treatment.

This same analysis is used with respect to know-how property. Wall Products, Inc, a closely held corporation that manufactured and sold "Plastorene" and "Morene" products, made payments to principal stockholders in exchange for the use of a secret formula. The IRS argued that payments to the researchers were compensation for services rendered under the premise that non-secret know-how is not considered property and, therefore, any related payments constitute compensation. However, the court held that there was a bona fide transfer of property in the form of secret know-how. The court did not address the hired-to-invent principle since the corporation did not hire the employees to perform the

[14] Chilton, McClain, Beausoleil, *supra* note 10. Lehman, *supra* note 11.

[15] Lehman, *supra* note 11.

[16] Beausoleil, *supra* note 10.

[17] Dated 8/8/02, promulgated in early December 2002. Section 6110(k)(3) provides that such pronouncements may not be used or cited as precedent, however, technical advice memorandums may give insight to the administration's position on the issue.

research and the research was conducted outside the scope of employment.[18]

The challenge for research institutions is to define "secret" know-how and apply it to the facts and circumstances of each transfer. The value of secret know-how is not the information transferred but the fact that the information is kept confidential. Thus, it is the wall of concealment built around the information that the licensee/buyer is willing to pay for that determines whether the know-how constitutes intellectual property. Historically, the IRS applies a higher standard than the courts when defining the term "secret."

The IRS limits transferable property to information that is secret formulas or secret processes. Rev. Proc. 69-19[19] provides that only the owners and confidential employees know of the information and that safeguards are taken to prevent unauthorized disclosure. The information must be more than merely rights to tangible evidence, such as blueprints, drawings or other physical material. Further, technical information that relates to the property must not be furnished on a continuing basis. Non-secret know-how may qualify for capital gains treatment only when in the form of services and those services are ancillary to the technology transferred.[20] The IRS has defined ancillary services as promoting the transferred property or by assisting or performing under a guarantee the start-up of the property.[21]

THE FUNDAMENTAL ISSUE IS WHETHER THE DISTRIBUTIONS MADE TO THE RESEARCHER CONSTITUTE COMPENSATION FOR SERVICES RENDERED OR REPRESENT INCOME FROM THE TRANSFER OF INTELLECTUAL PROPERTY.

In *Wall*, the court defined the concrete curing process as secret know-how even though the process was readily disclosed by performing a "reverse engineering" procedure.[22] The court in *DuPont* held that secret information includes customer lists, customer credit lists and news, suggesting secrecy attaches to a series or set of known materials.[23] In another case, the taxpayer found that the transfer of manuals that were available to competitors did not prevent permitting capital gains treatment.[24] Accordingly, an institution or researcher relying on these court cases should consider the tax risks that may arise with respect to the positions taken by the IRS. Legal definitions aside, the authorities clearly demonstrate that in determining the transfer of know-how property, the facts of each case dictate the outcome. Consequently, research institutions may avoid reporting the taxation of distributions as compensation by modifying policy and procedure statements, and assignment agreements. For example, institutions may require that the distributions paid from commercialized technology preclude revenues related to hired-to-invent agreements. Furthermore, hired-to-invent arrangements should be contracted for separately and distinctly from other licensed properties.

A large majority of licenses entered into by the higher education community includes non-secret know-how as services that are ancillary to the technology transferred. However, to the extent that non-secret know-how is more than ancillary or unrelated to the transfer, institutions need to make allocations necessary to report such payments as compensation. Similar to the hired-to-invent arrangements, it is recommended that research institutions enter into separate contracts when licensing such non-secret know-how services.

Moreover, such policies and agreements should be revised to include those factors that ensure a bona fide transfer of technology. Payments should evidence a legally binding agreement to pay a fixed amount that should continue regardless of changes to or termination in policy and after employment or death. Further, the payments should be in relation to the use of the property.

Copyrights. The courts apply the same analysis to the transfer of copyrights that is applied to patents and know-how, but replace the hired-to-invent principle with a "work-made-for-hire" principle.[25] Similar to patents and secret know-how properties, ownership of copyrights initially vests in the author. However, a provision in the federal copyright law provides that ownership of the property initially vests in the employer when the employee created the work within his or her scope of employment as work-made-for-hire unless the parties expressly contract otherwise.[26] This principle extends to independent contractors as well.[27] The consequence is that the

[18] Wall, *supra* note 6.
[19] 1969-2 CB 301.
[20] Rev. Rul. 64-56, *supra* note 6.
[21] *Id.*
[22] Wall, *supra* note 6.
[23] DuPont, *supra* note 6.
[24] U.S. Mineral Products, *supra* note 6.
[25] Boulez, 83 TC 584 (1984); Hill, 47 TC 613 (1967); Karrer, 51 AFTR 775, 152 F.Supp. 66 (Ct. Cl., 1957); Wodehouse, 38 AFTR 998, 177 F.2d 881 (CA-2, 1949); compare to Wodehouse, 38 AFTR 1248, 178 F.2d 987 (CA-4, 1949).
[26] See 17 USC section 101.
[27] Boulez, *supra* note 25; Samet v. Wells, Inc. v. Shalom Toy Co., Inc., 429 F. Supp. 895 (DC N.Y., 1977).

researcher cannot transfer property he or she does not own and, thus, any distributions made constitute compensation.

The courts' interpretation of the work-made-for-hire provision is similar to and parallels the hired-to-invent provision. The court in *Boulez* held that a world-renown musical conductor who was hired exclusively by the employer for the purpose of making phonograph records created copyright property that the employer owned.[28] In *Hill*, the court held that the payments made to an employee who was hired to produce programs as directed by the employer resulted in compensation.[29] A case on copyright infringement found that the property rights belonged to the Army regarding a statue created by soldiers who were relieved from regular military duties to work on the statue as part of a formal government-commissioned project.[30]

Research institutions should make the same adjustments to distribution policies and contracts for work-made-for-hire cases as with the invent-to-hire arrangements. Also, these documents should include the necessary factors to indicate a bona fide transfer of property rights.

Income recognized as royalties or as sales of capital assets

Once it has been determined that a bona fide transfer of property took place, the question becomes whether the researcher is entitled to capital gains treatment on the distributions he or she receives. The courts use the same analysis under both the patent and capital asset provisions to determine capital gains treatment (1) whether the property transferred is a recognized patent or a capital asset, (2) if so, whether the transfer constitutes a sale rather than a license arrangement and, (3) if so, whether the holding period for long-term assets is met. When these provisions are met, the income derived is entitled to the capital gains tax rate. However, when these requirements are not met, the payments are classified either as royalty income or income derived from the sales of short-term capital assets, both of which are subject to or[illegible] nary income tax rates.

Patent provision. Congress introduced this provision in 1954 to provide lower tax rates to individuals—in particular, professional inventors who typically are denied capital gains treatment under the capital asset provision.

A capital asset. Regulations under Section 1235 define patents using the terms provided under the provisions of title 35 of the United States Code, or as any foreign patents that grant rights similar to those of U.S. patents. It is not necessary that the patent or patent application for the invention be in existence for this provision to apply. Also, a patent includes future improvements[31] and undivided interests or fractional interests in the property as a whole.[32]

This provision, however, excludes sales of patentable property that are made to related persons, either directly or indirectly. Reg. 1.1235-2(f) defines "related person" as a member of the family, including a spouse, ancestors, and lineal descendants. Brothers and sisters, however, are excluded. "Related person" also includes corporations, partnerships, and certain trusts in which the holder maintains an ownership interest of 25% or more. The rationale is to prevent an effective transfer when a sale of patents is within the same economic family.[33]

Consequently, researchers should be made aware when licensing property independently that transfers to limited liability companies, corporations, or partnerships in which the researcher maintains a 25% interest or more may deny him or her capital gains treatment. In the alternative, if institutions make patent transfers to such entities on behalf of their researchers, they should maintain documentation to indicate that the transactions were at arm's length and not directed or controlled by the researcher in any way.

A sale or exchange. Section 1235 defines a "sale or exchange" as the transfer of all substantial rights to a patent, including undivided interests, by a holder. The terms may call for payment over a period generally coterminous with the use of the patent or contingent on the patent's productivity, use, or disposition. "Holder" is defined to include individuals whose efforts created the patent or those individuals, but for the creator's employer and related parties, who acquired an interest in the payment prior to actual reduction to practice of the property. The rationale is that a trans-

IT IS THE RESPONSIBILITY OF THE RESEARCH

NAVIGATE THE COMPLEXITIES OF EACH TRANSFER TO REPORT PROPERLY THE DISTRIBUTIONS AS TAXABLE INCOME.

[28] Boulez, [illegible] note 25
[29] Hill, *sup*[illegible]te 25.
[30] Scherr v. [illegible]iversal Ma[illegible]
[31] Heil, 38 [illegible] 989 (1961
[32] Reg. 1.1
[33] [illegible] & A[illegible] [illegible]ews, [illegible]954,

fer of all substantial rights is deemed a sale since the researcher has given away all the bundle of rights, keeping nothing of substance.

Reg 1.1235 provides examples of transfers that meet, may meet, and do not meet the "all substantial rights" standard. The holder can qualify for capital gains when retaining the following rights:

1. Legal title for the purpose of securing performance or payment with exclusive licenses or reservation in the nature of a condition subsequent.
2. Rights that are not inconsistent with the passage of ownership, such as a security interest or a vendor's lien.

The holder may meet the "all substantial rights" requirement when he or she retains the following:

1. The right to prohibit sublicensing or sub-assignment by the transferee.
2. The right to use or sell the property.

Conversely, retention of other rights defeats the applicability of this provision. Examples include:

1. Limiting the rights geographically within the country of issuance.
2. Limiting by agreement the duration to a period less than the remaining life of the patent.
3. Terminating the transfer at will.
4. Granting less than all claims or inventions in the patent that exist and have value at the time of the grant.
5. Granting fields of use that are less than all the rights covered by the patent that exist and have value at the time of the grant.

HISTORICALLY, THE IRS APPLIES A HIGHER STANDARD THAN THE COURTS WHEN DEFINING THE TERM 'SECRET.'

The court in *Taylor* gives guidance as to the application of the term "all substantial rights." William Taylor, who patented in the U.S. a "square" manhole (advertised as the "safe" and "silent" answer to sewage repair), entered into three agreements to transfer the patent rights. In the first agreement, the right to "manufacture" was exclusively transferred to a manufacturer to make products in Ontario. However, the remaining fundamental rights to "use" and "sell" were not clearly transferred as exclusive rights. In the second agreement, the inventor transferred non-exclusive rights to "make, use and sell" the invention throughout Canada's maritime provinces, keeping the rights to transfer the patent to other parties. Both agreements limited the transferees' rights to assign any rights and prevented them from suing in their own name for infringement cases.

In the third agreement, the inventor, in general terms, transferred expressly the exclusive rights to "make and sell" the invention and by implication "use" the property in the United Kingdom. Taylor limited the duration of the agreement to one year with an option by the transferee to renew the contract for the term of the patent. The arrangement also allowed the transferee the right to institute or join Taylor in any infringement proceedings at his request. Further, Taylor retained the right to veto assignments to other parties.

The court held that the first two agreements constituted licenses but found the third agreement transferred "all substantial rights," effecting a sale. In the first two agreements, the failure to transfer exclusively two of those essential rights to a patent, "use and sell," combined with limitations on assignments and infringements, resulted in the inventor retaining substantial rights significant to defeat the transfer as a sale. In the third agreement, however, the transfer, taken as a whole, represented the appropriate "bundle of rights." The agreement transferred all essential rights to the patent and did not impair the duration of the arrangement when allowing the transferee under the option to either terminate or continue the arrangement. The agreement permitted the transferee to sue in its own name for infringement cases and the retention of the rights to veto assignments, by itself, was not enough to prevent a sale.[34]

The determination of whether the conditions of the assignment agreement meet the "all substantial rights" standard is based on the facts and circumstances of each transfer, including providing documentation that gives the values of the rights at the time of the transfer. For example, property transferred by an inventor who retained a substantial right, the right to terminate the exclusivity of the agreement, qualified for capital gains treatment since the right had no significant, practical or commercial value when the contract was entered into and the clause was not exercised.[35] Also, this standard is not affected by licenses previously granted to the federal government for government purposes. The court in *First National Trust and Savings Bank of San Diego*[36] held that the exclusive license to a local business

[34] Taylor, TCM 70-325.
[35] Bannister, 3 TR 2d 369, ? F.2d 175 A-5, 1958).
[36] 9 AFTR2d 9 200 F. Supp '4 (DC Cal 961).

constituted a sale regardless of the fact that the patent had a pre-existing non-exclusive license to the U.S. government to manufacture and sell devices.

Holding period. Section 1235 defines the holding requirement as a long-term period per se. The effective transfer of "all substantial rights" by definition deems the holding period to be met when it provides "a transfer ... of all substantial rights ... by any holder shall be considered a sale or exchange of a capital asset held for more than 1 year."

Alternatively, when the patent fails to meet the requirements under this provision, it may qualify for capital gains treatment under the capital asset provision. For example, a transfer to a related party will cause the transfer to fall outside this provision. Reg. 1.1235-1(b) provides that when this provision does not apply, the "tax consequences of such transactions shall be determined under other provisions of the internal revenue laws." The IRS confirmed this position when it applied the "all substantial rights" standard to those patents that seek capital gains treatment under the capital asset provision in default of this provision.[37]

Capital asset provision. Patents, copyrights, and secret know-how may qualify for capital gains treatment; provided the requirements under this provision are met.[38]

Capital asset. Reg. 1221-1 defines capital assets to include all property not specifically excluded by this section. "Excluded" property includes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Typically, with respect to technology transfers, this requirement applies to professional inventors who engage in the business of selling inventions. The questions asked by the courts to determine when this property is excluded as a capital asset are (1) whether the inventor engages in this activity frequently, examining the history of sales or licenses made and the number of inventions; (2) whether the inventor assumes the risk of commercializing the property, or depends on the employer to market the products; and (3) the devotion by the inventor to develop technology beyond the scope of employment.

For instance, in *Lockhart*,[39] the court held that an inventor who had 37 inventions in 19 years was engaged in business and, thereby, disallowed capital gains treatment. In *Avery*,[40] the court held that the creator was a professional inventor when he procured outside his scope of employment 12 patents in 17 years, selling only two inventions to his employer. On the other hand, the court in *Myers*[41] held that the employee, who for close to ten years worked in engineering and sales promotion and who transferred his one and only patent to his employer, was not holding property for sale in a trade or business. In *Dupont*, the court made the distinction between operating a business and using technology as part of that business when it allowed capital gains treatment.

THE AUTHORITIES CLEARLY DEMONSTRATE THAT IN DETERMINING THE TRANSFER OF KNOW-HOW PROPERTY, THE FACTS OF EACH CASE DICTATE THE OUTCOME.

The definition of capital assets excludes copyrights, including literary, musical, or artistic composition, and similar property for those taxpayers whose personal efforts created such property or, in general, those persons who inherit that taxpayer's basis.[42] "Similar property" includes a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection. "Personal efforts of the taxpayer" is defined to include performing "literary, theatrical, musical, artistic, or other creative productive work which affirmatively contributes to the creation of the property, or if such taxpayer directs or guides others in the performance of such work." A corporate executive who "merely has administrative control" of the creators and "does not substantially engage in the direction or guidance of such persons in their performances" does not qualify as a creator.[43]

This exclusion imposes broad language that raises questions as to whether it applies to patents and secret know-how that are also copyrightable. Reg. 1.1221-1(c)(1) provides that

[37] Rev. Rul. 69-482, *supra* note 4. It is the opinion of this author that in practical terms, the decision in Poole,46 TC 392 (1966) is rendered moot by this ruling. The court in Poole held that a patent transferred to a related party that was ineligible under Section 1235 was precluded from capital gains treatment under other provisions.

[38] Section 1231 is virtually identical for purposes of this paper to Section 1221 and corresponding provisions, except that, because Section 1231 pertains to depreciable property, the resulting gain may be treated as ordinary income under the recapture rules in Section 1245, under the 'unrecaptured' net losses rule in Section 1231, or when sales are made to related parties per Section 1239.

[39] Lockhart, 2 AFTR 2d 5342, 258 F.2d 343 (CA-3, 1958).

[40] 47 BTA 538 (1942).

[41] Myers, 6 TC 258 (1946).

[42] Reg. 1221-1(c)(1). Further, Reg. 1221-1(c)(2) extends the definition of copyrights to those sales or dispositions made after 7/25/69 that include letters, memorandums, or similar property. Similar property includes a draft of a speech, a manuscript, a research paper, an oral recording of any type, a transcript of an oral recording, a transcript of an oral interview or of dictation, among other things.

[43] Section 1221(a)(3)(A); Reg. 1.1221-1(c).

the term "similar property" does not include a "patent or an invention, or a design which may be protected *only* under patent law and not under the copyright law [emphasis added]." The corollary is that when the property may be protected under copyright and another classification, the property falls within the definition of "similar property" and, thus, is denied classification as a capital asset. Importantly, this line of thought applies to designs that may be recognized as both copyrights and patents as well as to computer software technology that may qualify as a copyright, patent, or secret know-how.

Arguably, designs and computer software that meet the requirements of the patent provision should not be denied capital gains treatment even when considered to be copyright property. The court in *Gilson*[44] held that a taxpayer that sold or licensed patent designs qualified for capital gains treatment under the patent provision regardless of the fact that the property was also copyrightable. However, the question remains open for patents that qualify in the alternative under the capital asset provision and secret know-how property. Although it seems logical to assume that the language in the regulations is overly broad, if inadvertently, in light of industry practices, it is a point of risk when analyzing the tax treatment of distributions.

Thus, income derived from transferred property that is either held for sale in the ordinary course of trade or business or derived from licensing copyrights created by the author is classified as royalty income.

Sale or exchange. A sale or exchange is defined generally as a transfer of the sole and exclusive rights to make, use, and sell the property.[45] The IRS has taken the view that the term "exclusive rights to make, use and sell" is interchangeable with the "all substantial rights" standard and uses this standard to determine effective transfers for technology under this provision.[46] Also, the courts have taken the same position with respect to secret know-how property.[47]

One can argue, however, that transfers of certain patents and copyrights may constitute sales even though the "all substantial rights" standard is not met. For instance, case law prior to the enactment of the patent provision held that a patent may be treated as a sale when segregated into geographical designations so long as the entire bundle was transferred.[48] This position contradicts Reg. 1.1235-1, cited above, which provides that a transfer that retains rights geographically within the country of issuance is reduced to a license rather than a sale. Examples of such transfers generally include geographical and fields of use limitations. It seems likely, however, based on the position taken by the IRS on this point both before and after the issuance of the patent provision, that it will contest any positions taken that differs from the application of the "all substantial rights" standard. Proper planning dictates that research institutions consider the potential tax risks should these situations arise.

Holding period. Unlike with the patent provision, the holding period is not a given. Under Section 1222, to qualify for long-term capital gains a capital asset must be held for more than one year. The courts provide that the holding period for an invention begins on the date the original invention is reduced to practical application.[49] In general, an invention is reduced to practice when a drawing, model, or property in question is prepared to enable those skilled in that discipline to produce the invention.[50] In *Myers*, the property met the holding period since the drawings of the invention were done two years before the patent was assigned and filed upon.[51] In *Kronner*, the taxpayer first produced a working model of his new clutch two years prior to assignment.[52]

Accordingly, assignment contracts in which the employee immediately assigns his or her technology to the employer cannot, by default,

[44] Gilson, *supra* note 7.

[45] Waterman v. MacKenzie, 138 U.S. 252 (1891); Myers, *supra* note 41; U.S. Mineral, *supra* note 6.

[46] Rev. Rul. 64-56, *supra* note 6; Rev. Rul. 69-482, *supra* note 4; Rev. Rul. 78-328, 1978-2 CB 215.

[47] Pickren, 19 AFTR 2d 1561, 378 F.2d 595 (CA-5, 1967); U.S Mineral, *supra* note 6.

[48] The court in Rodgers, 51 TC 927 (1969), relied on patent tax law prior to the enactment of the patent provision in determining whether the taxpayer was entitled to capital gains under the patent provision. The court held against the "patent" regulations that prevent an effective transfer when retained rights include geographical limitations in the country of issuance. The taxpayer who gave exclusive rights in a U.S. patent to a transferee in only the state of California while retaining rights to license the patent in other states throughout the country was permitted to treat the arrangement as a sale. In Kueneman, 68 TC 609 (1977) the Tax Court reversed its position in Rodgers with respect to patents that qualify under the patent provision.

[49] Diescher 36 BTA 732 (1937); Myers, *supra* at note 41; Kronner, 43 AFTR 574, 110 F. Supp. 730 (Ct. Cl. 1953).

[50] Diescher, *supra* note 49.

[51] Myers, *supra* note 41.

[52] Kronner, *supra* note 49.

meet the holding requirement for long-term capital gains under this provision.[53] Thus, in the typical scenario, the researcher who is a faculty member at a university and transfers computer software technology to the university pursuant to his or her assignment agreement will not be entitled to capital gains treatment unless he or she files for a patent that qualifies under the patent provision. The researcher, however, may meet the holding period requirement if he or she receives outright ownership of the property or the property is returned to the researcher once the university has determined not to pursue licensing the property. The researcher's challenge then is to avoid classification as a professional inventor mentioned above.

As a side note, failure to meet the holding period for long-term capital gains does not change the character of the transaction. Intellectual property that meets these requirements except for the holding period is classified as a short-term capital asset. Although the gain derived is subject to ordinary income tax rates, the applicability of the capital asset character may pertain to other areas of the tax law, such as the personal holding company rules.

To recap, the patent provision applies only to patentable property when "all substantial rights" have been transferred to unrelated parties. The capital asset provision applies to patents, copyrights, and secret know-how but excludes from this provision property transferred by professional inventors and copyright property in the hands of the author. Income from such property is treated as royalty income.

Similar to the patent provision, the "all substantial rights" standard generally defines a sale. Unlike the patent provision, the inventor must actually hold the property for more than one year. Capital assets held for one year or less are short-term capital assets, income from the sale of which is subject to ordinary income tax rates, whereas capital assets held for more than one year are long-term capital assets, sales of which qualify for preferential capital gains treatment. The interpretations or positions taken with respect to each of these provisions are based on a facts-and-circumstances determination.

Reporting the tax consequences of distributions

The complexities and difficulties that arise under the traditional analytical framework dictate that research institutions adopt a modified approach when meeting the reporting requirements. The Code requires institutions to classify distributions into any of the three buckets as either compensation, royalties, or capital gains, reporting the first two categories on Form W-2 or Form 1099 with no reporting for the last category. Under this conventional method, institutions must incur significant administrative costs to report the distributions as taxable income. For instance, institutions must review the proper classification of each transaction—i.e., patents that qualify for capital gains treatment or copyrights that are subject to ordinary income taxes—and must assign or allocate values to mixed or commingled transactions, such as those that include both capital gain property and ordinary income property. Also, the institutions bear the risk of misclassifying the transactions and assigning or allocating values improperly within mixed transactions, thereby failing to comply with Code requirements and possibly jeopardizing relations with their researchers. This modified method, however, provides a standardized and systematic approach to reporting these distributions in accordance with IRS requirements will foster better relations with researchers, eliminate the risks and exposure, and minimize administrative costs.

RESEARCH INSTITUTIONS MAY AVOID REPORTING THE TAXATION OF DISTRIBUTIONS AS COMPENSATION BY MODIFYING POLICY AND PROCEDURE STATEMENTS, AND AGREEMENTS.

Modified approach to reporting requirements. It is recommended that, aside from compensation matters discussed above,[54] institutions report all distributions as royalties on Form 1099-Misc. Clearly, this approach provides assurance to the IRS that the distributions are reported accurately and consistently and removes the margin of error for misclassified transactions or improperly valued properties. Relations between the institution and its researchers are better managed and administrative costs are minimized appropriately. Further, this approach seems grounded in both practicality and prudence. As the tradi-

[53] Kuzmick, 11 TC 288 (1948).

[54] Institutions must separate the compensation from other income and report as either wages or non-employee compensation. As mentioned, identifying and reporting compensation is best managed by making revisions or amendments to distribution policies and assignment agreements to separately contract for hired-to-invent and work-made-for-hire situations. Non-secret know-how that amounts to more than ancillary services should be treated similarly. Also, these policies and agreements should include the factors necessary for a bona fide transfer.

tional framework illustrates, tax consequences turn on the facts and circumstances of each transaction. Logic therefore asserts that, in the interest of all parties, institutions pass the process of classifying properties and allocating values into the hands of the researcher, the person who is most familiar with the information in the best position to report the taxable income properly.

Manages risk. This approach allows institutions to manage risks and exposure. The institution has no margin of error in overvaluing capital gains paid. Eliminated is the inherent tension that may arise when a researcher disagrees with or challenges an institution's method of allocation. The institution is insulated from the possibility of becoming a necessary party to an IRS examination of one of its researchers, and has no allocation methodology to defend should the IRS audit it. Thus, the institution has effectively removed itself from misrepresenting the tax situation of its researchers on a matter of potentially high risk.

Avoids intermediate sanctions provision. Private institutions and certain entities affiliated with state universities run a risk of violating the intermediate sanctions provision. This provision applies to charitable and social welfare entities organized under Section 501(c)(3) and Section 501(c)(4) if the organization has paid "unreasonable compensation" to a disqualified person. Disqualified persons include individuals who exercise significant influence over the affairs of the organization. A finding of unreasonable compensation may result in a penalty to the disqualified person of 25% on the amount of the excess or "unreasonable" amount and a penalty to the insider of 10% on the same amount with a limit of $10,000 per transaction. Insiders are defined as organization managers who knowingly participate in the transaction. These sanctions must be disclosed on the Form 990, "Return of Organization Exempt from Income Tax." This return is subject to public inspection.[55]

Moreover, this provision includes a per se sanction for not reporting compensation

[55] The topic of intermediate sanctions is beyond the scope of this article. For a basic understanding, including definitions of "disqualified persons," "insiders," and "affiliates of state agencies" see Section 4958 and the regulations thereunder.

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when it is earned, dubbed "excess benefit transactions."[56] These transactions are subject to the penalties and disclosure requirements. Under the conventional method, a research institution may trigger these sanctions when it misclassifies or overvalues long-term capital gains paid to a researcher because it would not file any form and, thereby, not report currently that portion of the overvalued income when earned. Reporting capital gains on Form 1099 avoids this sanction and its disclosure requirements.

Assists the researcher. This modification allows the institution to continue to procure good relations with its researchers. Using the framework, institutions may assist the researchers with their tax situations by informing them of tax consequences. Direct reporting allows the researcher to accumulate first hand the documentation necessary to build a defensible position if audited by the IRS, similar to the taxpayers in the *Chilton* and *McClain* cases. This approach promotes and protects the tax interests of the researcher.

Abates administrative expenses. The institution minimizes unnecessary administrative costs. Depending on the volume of licensing, institutions may incur the cost of full-time employment to make the precise allocations required by the tax law. The institution avoids the difficulty in obtaining approval for these ministerial expenses and may reallocate resources to purposes more central to its core mission.

Complies with IRS standards. To report capital gains as royalties on Form 1099-Misc is not inconsistent with IRS standards since, under these circumstances, no other form for reporting capital gains is available. The institution is taking a fail-safe position to report income that would otherwise not be reported and meets the spirit of compliance. In TAM 200249002, noted above, the university reported the distributions as royalties and the IRS made no mention nor provided any correction when it granted capital gains treatment to the researcher. This approach provides a safe harbor that promotes the cornerstone principles of prudence and conservatism that satisfies the concerns of the IRS. As a testimonial to its acceptance, a large preponderance of research universities currently reports virtually all distributions as royalties on Form 1099-Misc.

Conclusion

With the reduction in the long-term capital gains tax rates, research institutions should revisit the traditional analytical framework to assist their researchers in determining the tax consequences of distributions paid to them. To the extent that capital gains treatment is available, institutions have helped the researchers to put money into their pockets from the resulting tax savings. Also, reporting these transactions in a standardized and consistent method meets the concerns and interests of all parties. ■

[56] Section 4958(c)(