VEDDER PRICE

IP Strategies

Trends in patent, copyright, trademark and technology development and protection

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TAX ASPECTS OF SELLING AND LICENSING INTELLECTUAL PROPERTY

The sale or license of a patent, copyright, trademark, trade name, and other similar intellectual property right (collectively, "Intellectual Property" or "IP"), whether by agreement or as a result of litigation, has tax consequences that transferors and transferees must be aware of to ensure that IP is transferred on a tax advantageous basis. The tax consequences of transferring IP varies depending on whether the IP is sold or licensed and varies depending on the particular type of IP involved. Patents, know-how, copyrights, trademarks and trade names each have unique U.S. federal income tax consequences, as discussed in detail below. Before these rules are discussed however, it is important to first understand the federal income tax consequences of selling and licensing Intellectual Property in general.

Sales v. License — In General

A person who sells/assigns all (or substantially all) of their rights to Intellectual Property will generally be treated as having "sold" their interest in the IP asset for federal income tax purposes, and generally will be taxed at capital gain rates. A buyer on the other hand, will generally be required to depreciate or amortize the purchase price of the acquired IP over a specific period of time. This period of time depends on several factors which are outside the scope of this article. However, acquired IP is generally depreciated or amortized over a mandatory 15 year period, the remaining useful life of the IP or some other method permitted under the Internal Revenue Code of 1986, as amended (the "Internal Revenue Code").

In contrast, when Intellectual Property is licensed, the licensor typically has ordinary income to the extent of money actually or constructively received from the licensee, and the licensee typically has a business expense deduction for the amount of royalties incurred.

Example. The chart on page 2 illustrates these rules. Assume a person transfers a patent worth $150 and the transferor has an adjusted tax basis in the patent of $50. Also assume that the patent had a remaining useful life of 15 years, but, if licensed would only be licensed for 10 years.

As you will notice in the illustration on page 2, the seller will net $135 ($150 purchase price – $15 tax) if the IP is sold, but will only net $97.50 if the IP is licensed (($15 annual royalty – $5.25 tax) x 10 years). However, the licensor will still have an asset with a remaining useful life of five years upon termination of the license.

These numbers reflect two key factors. First, when you sell an asset, you can generally offset the purchase price received with your basis, if any, in the asset sold, whereas in a license transaction you cannot. And second, as a result of federal tax legislation recently signed into law, the marginal difference between the highest long-term capital gain rate and the highest ordinary income tax rate for individuals is 20%. The maximum long-term capital gain tax rate is 15% and the maximum personal income tax rate is 35% (note, corporations generally pay the same rate of tax for net capital gains as ordinary income (maximum 35%)). Furthermore, if a seller has capital losses from unrelated transactions (for example from current or previous stock market transactions), those capital losses could offset some or all of the transferor's gain upon the sale of the IP, potentially netting zero federal income tax on the transaction. Royalty income, unlike sale proceeds, is ordinary income and cannot generally be offset by any of the transferor's unrelated capital losses.

EXAMPLE	
<u>Sales Transaction</u>	**<u>License Transaction</u>**
Seller: $100 ($150 - $50) <u>x 15</u>% (Long Term Cap. Gain Rate) $ 15 Federal Income Tax	**Licensor:** $150/10 yrs. = $15/yr. Royalty $15 x 35% = $5.25/yr. of Tax
Buyer: $150/15 yrs. = $10/yr. deduction	**Licensee:** Business expense deduction of $15/yr.

With respect to the buyer/assignee or licensee, the tax consequences are different as well. The buyer in this example will recover its cost over fifteen years yielding a deduction of $10/year, while the licensee in this example will have a business expense deduction of $15/year for ten years. Note, the higher deduction is only good if you have enough income to offset it.

Now that the general rules of taxation are laid out, let's turn to how you determine whether a transaction is a sale or a license for federal income tax purposes.

DETERMINING WHETHER A TRANSACTION IS A SALE OR A LICENSE

To determine whether a transaction is a sale or a license for federal income tax purposes, several factors need to be considered: (1) the type of IP (*e.g.*, patent, copyright, trademark, etc. — as discussed below); (2) the facts and circumstances of the transaction; and (3) who has the "benefits and burdens" of ownership.

The transfer of title, although indicative of a sale, is not necessarily conclusive. Similarly, the name given to the agreement (*e.g.*, License Agreement) although helpful, is also not conclusive. Some courts, have analogized property rights to a "bundle of sticks." The more sticks transferred, the more likely the transaction will be characterized as a sale for federal income tax purposes. Conversely, the more sticks retained, the more likely the transaction will be characterized as a license for federal income tax purposes.

The Internal Revenue Service ("IRS") can and will recast a transaction to reflect its substance and not its form. For example, the transfer of an exclusive license for the life of an IP asset will likely be treated as a "sale" for federal income tax purposes and not as a license. This is because the transferor has relinquished all valuable rights to the IP for remainder of its life. Stated differently, the transferor has transferred all or substantially all of its "bundle of sticks" causing it to be treated as a sale and not a license. If a license is recharacterized as a sale by the IRS, royalty payments would be recast as installment sale payments. This could dramatically change the anticipated tax consequences for both the transfer and the transferee as demonstrated above.

SALES V. LICNSE — PATENTS, KNOW-HOW, COPYRIGHTS, TRADEMARKS AND TRADENAMES

Each type of Intellectual Property is treated differently for federal income tax purposes. This is a function of specific legislative enactments and the way differing lines of case law have developed.

Patents

A patent owner's interest in its patent consists primarily of the exclusive rights to "make, use, sell, offer to sell and import" the patented item. Therefore, in order to "sell" an interest in a patent, the sale must consist of the transfer of all of these rights (or an undivided interest in all these rights). If the patent owner does not part with all of these exclusive rights (other than the retention of certain *de minimis* rights), the transaction will generally be treated as a license.

A patent owner might be able to "sell" less than all of his or her rights to a patent and still obtain favorable tax treatment. For example, the owner may be able to sell the rights to a patent with in a particular restriction (*e.g.*, particular geographic area or product line). However, the transferee must have the exclusive rights to make, use, sell, offer to sell and import the patented item within this restriction. Note, transferring less than all of your rights to a patent must be done carefully to ensure "sale" treatment.

Finally, unlike certain other IP, the method of paying for a patent does not determined whether transaction is a sale or license. Consideration can be fixed or contingent (based on productivity or profits) and it can be payable in one lump sum or over a period of time. However, if you sell a patent and receive contingent consideration payable over a period of time, care must be taken to ensure "sale" treatment because this type of transaction could resemble a license.

Special Rule for the Sale Of A Patent Created By An Individual. The Internal Revenue Code carves out a special exception for individual (*i.e.*, not corporate) inventors of a patent, and certain financial backers of such inventors prior to the patent's actual reduction to practice. If such a person sells "all substantial rights" to his or her patent (other then to a related party), the patent will generally be considered a sale of a long-term capital asset and taxed at favorable federal income tax rates regardless of the length of time the patent or patent application was held.

The phrase "all substantial rights" generally means all rights to the patent which are of value at the time the rights to the patent are transferred. This is a facts and circumstances test. However, this test will *not* be satisfied if the grant of rights is: limited geographically within country of issuance; limited to a period of less than the remaining life of the patent; less than all rights to fields of use within the trade or industry; and, less than all of the "claims or inventions" covered by the patent which exist and have value at the time of the grant.

Long term capital gain treatment does not generally apply to a transfer by an employee to his or her employer. If the patent is acquired by an employer from its inventor/ employee, care must be taken to distinguish between payments made for the transfer and salary payments. The principal behind this is that the employee who was "hired to invent" does not have any rights in those inventions for which he or she can sell. Thus, payments to the employee will typically be treated as additional compensation and would be subject to ordinary income and payroll taxes instead of capital gain taxes.

This special rule with respect to individual inventors is specific only to patents. There is no counterpart rule for copyrights, trademarks or know how. In fact, copyrights have a rule that is practically the opposite to this rule.

Know-How

Neither the Internal Revenue Code nor the regulations thereunder define "know-how," but the courts, including the Tax Court, have characterized know-how as "unpatented technology." Know-how consists of things such as technical data, secret processes and trade secrets. To qualify as a "sale," the transferor must generally transfer all "substantial rights" to the know-how *and* the transferee must generally have the right to bar unauthorized disclosure of the know-how. If the transferor retains any substantial rights to the know-how, the transaction will likely be deemed a license and the proceeds will be taxed as ordinary income.

The interesting difference with know-how is that, even if a transfer qualifies as a sale for federal income tax purposes, the know-how must be of a type to qualify as a "capital asset" (as defined in the Internal Revenue Code) to obtain favorable tax treatment. To qualify as such an asset, an item being sold must be "property" (another tax concept). The IRS has specifically stated that two categories of know-how are property for capital gain purposes: certain secret processes and formulas and other secret information relating to a device or process that is in the general nature of a patentable invention. Case law has expanded on this definition, but each situation is unique and must be carefully examined. Therefore, although the transfer of know-how may qualify as a "sale" for federal income tax purposes, the transaction may nonetheless be taxed at ordinary income tax rates.

Copyrights

The federal income tax treatment of a transfer of a copyright depends on both the substance of the transaction (*e.g.*, how many "sticks" are transferred), and who is selling the copyright. To get favorable tax treatment, if available (see below), the seller must again part with "all substantial rights" in a given medium of expression. An exclusive license in a medium of publication (*e.g.* movie rights) for the life of the copyright is generally treated as a "sale" for federal income tax purposes. A non-exclusive license will generally be taxed and treated as a license.

Copyrights, like patents, have a special rule for the person whose personal efforts created the copyrighted work. However, this rule is the opposite as that for patents. If the creator of a copyrighted work sells all of his or her interest in the copyright, the sale will be taxed at ordinary income tax rates and not capital gain tax rates. The only people who can qualify to receive capital gain tax treatment on the sale of a copyright is generally anyone other than the person who created the copyrighted work, certain persons for whom the copyrighted work was created and their donees.

Because the creator of a copyrighted work is taxed the same regardless of whether their interest is sold or licensed, the creator may not care how the transfer is structured. But there are other tax considerations a creator-transferor should consider. For example, the creator-transferor can offset the purchase price received for the copyright with his or her basis in the copyright, if any, in computing the amount of tax upon a sale, which is not possible if the protected work is licensed. In addition, a license transaction can generate passive income which could have adverse tax consequences (*e.g.*, application of personal holding company rules). Finally, the buyer may have a preference for tax purposes as to whether the copyrighted work should be licensed or purchased and the creator-transferor's relative neutrality could be utilized to structure a transaction advantageous to both parties.

Trademarks and Trade Names

A trademark or trade name can generally be "sold" if the transferor does not retain any "significant power, right, or continuing interests" with respect to the subject matter of the trademark or trade name. If, however, any such rights (defined below) are retained, the transaction will be generally be taxed and treated as a license for federal income tax purposes.

The term "significant power, right, or continuing interests" includes, but is not limited to, the following rights with respect to the interest transferred: 1) a right to disapprove any assignment of such interest, or any part there of; 2) a right to terminate at will; 3) a right to prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote such products or services; 4) a right to require that the transferee sell or advertise only products or services of the transferor; 5) a right to require that the transferee purchase essentially all of its supplies and equipment from the transferor; and 6) a right to payment contingent on the productivity, use, or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.

These factors are objective indicia of a license and are consistent with the "bundle of sticks" analogy. For example, if a transferor has a right to terminate a trademark at will, the trademark should be characterized as a license because that would not be consistent with a licensee's ownership of the IP. Conversely, it would be consistent with transferor's ownership of the IP.

Finally, unlike patents and copyrights, contingent payments may pose a problem. Contingent amounts received or accrued by the transferor on account of a transfer, sale or other disposition of a trademark or trade name are generally treated as ordinary income. Amounts are contingent if they depend upon the productivity, use, or disposition of the transferred property. Therefore, if a transaction is structured as a sale, the amounts received may nonetheless be taxed as ordinary income if such payments are contingent on the productivity, use or disposition of the trademark or trade name.

CONCLUSION

Patents, know-how, copyrights, trademarks and trade names each have unique federal income tax consequences that transferors and transferees must be aware of to ensure that IP is transferred on a tax-advantageous basis.

MADRID PROTOCOL: THE INTERNATIONAL TRADEMARK APPLICATION

Effective November 2, 2003, the Madrid Protocol Implementation Act of 2002 (MPIA) will introduce a new and relatively easy and inexpensive way for U.S. trademark application and registration holders (trademark holders) to pursue multiple associated foreign trademark registrations. Under MPIA, trademark holders will be able to use a single international trademark application to pursue multiple foreign trademarks from among the fifty eight countries currently a party to the Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks (Madrid Protocol). A list of the countries, fees and other information can be found on the World Intellectual Property Organization (WIPO) web site: http://www.wipo.int/madrid/en/.

Advantages

The Madrid Protocol provides advantages in both the application and post-registration phases of the foreign trademark process. The advantages in the application phase include:

1. the use of a single application regardless of the number of countries designated;
2. the application need only be in English; and
3. the application is filed locally with the United States Patent and Trademark Office (PTO).

The advantages in the post-registration phase include:

1. the existence of a guaranteed period (12 to 18 months) in which potential grounds of refusal to protect a mark must be raised by the individual designated states;
2. additional countries can be designated after the initial registration;
3. a single location is provided for which to record transfers, name and address changes, etc.; and
4. a single request for renewal (10 year renewal periods) paid to the International Bureau of WIPO (IB) covers all of the designated states.

Application Phase

The application phase involves both the PTO and the IB. Procedurally, a trademark holder files an international application with the PTO. Next, the PTO certifies that the information on the international application accurately reflects the information relating to the corresponding U.S. application or registration and then transmits the international application to the IB. The IB then reviews the international application to assure that the appropriate fees have been paid and that the application otherwise complies with the Madrid Protocol filing requirements. As such, the IB does not perform any substantive evaluation relating as to whether a mark qualifies for protection in any forum or country. Once passing the initial review, the IB registers the mark, publishes it in the WIPO Gazette of International Marks, sends a certificate to the owner, and notifies the designated countries. If the international application is filed within six months of the U.S. trademark application and claims priority thereto, the international registration effective date is the same as the U.S. trademark's filing date and this date is subsequently treated as the date that the mark was filed with each of the designated countries.

Examination Phase

The examination phase involves both the designated countries and the IB. Once notified by the IB, the designated countries will examine the international application under its own trademark laws. The trademark office of any designated county has the right to refuse trademark protection on any grounds on which an application filed directly with such country could be refused. Any such refusal is recorded in the IB's International Register. Further, the trademark holder has the same right to contest the refusal of trademark protection as an applicant who filed with the examining trademark office directly. To the extent that the examining trademark office limits an application to only some of its originally designated goods, and where the holder does not contest such limitation, the mark then issues for such limited goods. An examining trademark office must generally issue a refusal of registration within twelve months from the date it was notified of the designation, but may extend this period six additional months by request. Beyond this extended eighteen month period, a registration may be still refused based on an opposition. However, within the eighteen month period the examining trademark office must notify the IB of the possibility of such an opposition. Therefore, at the end of the eighteen month period the trademark holder will know the status of his mark in all of the designated countries.

Recordation

The Madrid Protocol provides for recordation of the following items in the international register:

1. change of name or address of the holder;
2. change in ownership of the registration;
3. limitation of the list of goods;
4. renunciation of the protection with respect to one or more of the designated countries; and
5. cancellation of the international registration. Such recordation simply requires the filing of a form with the IB and payment of an associated fee.

The recordation is effective for all designated countries concerned.

Five Year Probation Period

For five years after the international registration, such registration is dependent on the corresponding application or registration in the PTO. During this time any withdrawal or cancellation of the PTO application, whether occurring during this period, or occurring after this period for an action begun during such period, results in the cancellation of the international application. To the extent that the withdrawal or cancellation is simply a limitation of the original set of goods, the corresponding international application will also be so partially cancelled. Any such negative activity at the PTO can be countered by transforming the international registration into a series of national applications in the desired designated countries without losing the date of the original international registration. However, if the five year term expires without cancellation of the international application, the international application then stands on its own independently from the originally filed PTO application.

Current Status Of U.S. Regulations

The PTO is currently in the rulemaking process regarding implementing the Madrid Protocol. The Federal Register of March 28, 2003, includes a notice of proposed rule making regarding the Madrid Protocol and includes a text of the proposed regulations. The deadline for comments was May 27, 2003 and a public hearing was held on May 30, 2003.

DAMAGES AS A RESULT OF PATENT INFRINGEMENT MAY NOW BEGIN TO ACCRUE AS OF PUBLICATION OF A PATENT APPLICATION

The Intellectual Property and Communications Omnibus Reform Act of 1999 (the "Act") requires that patent applications filed on or after November 29, 2000 be published 18 months after the application's earliest priority date unless the applicant does not intend to foreign file. As a result of the Act, instead of waiting until a patent issues, the patent laws now grant provisional rights to a patentee to begin to recover reasonable royalties as a result of patent infringement beginning on the date of publication. Prior to the Act, a patentee could collect damages, such as reasonable royalties or lost profits, from an infringer only after the patent issued. Now, if an applicant discovers that a competitor is practicing the subject matter claimed in the published application before the patent issues, the applicant may begin to calculate reasonable royalties starting with the publication of the patent application as opposed to issuance of the patent. In addition, the competitor can now analyze the published application to determine the likely scope of the claims and mitigate their damages by redesigning their product so as not to infringe the claims in the published patent application. Although the claims may later be broadened, the information gleaned by reviewing the prosecution history provides the competitor with a better understanding of the risks of its own product development.

If an application is published, the Act grants limited provisional rights to the applicant. According to the Act, these limited provisional rights give the applicant the right to a reasonable royalty against one who makes, uses, offers for sale, sells, or imports in the United States the invention as claimed in the published application, subject to the following conditions. First, although the Act provides for a reasonable royalty beginning on the date of publication, no explicit provisions for lost profits or any other type of damages as a result of patent infringement are established in the patent statute.

Second, in order for reasonable royalties to begin to accrue as of publication of the patent application, the claims in the published application must be "substantially identical" to the invention as claimed in the issued patent. The meaning of "substantially identical" is not defined in the statute. It may be that modification of a published claim that substantively changes its scope will not be considered to be substantially identical with an issued claim. Therefore, in order to maximize the potential provisional rights, applicants should attempt to have a range of claims in the published application, *e.g.*, the range of claims should include claims having a broad scope and claims having a narrow scope. This will provide the applicant with a better chance of having some of the published claims substantially identical to an issued claim since a published narrow claim may issue without modification even when a published broad claim requires substantial modification. The Act also permits applicants to redact portions of an application for publishing. This enables an applicant to prevent publication of material that will not be published internationally.

The third condition that must be met in order for provisional rights to be available is that the potential infringer must be given "actual notice" of the published application. What is required to provide "actual notice" is not defined in the Act. However, the legislative history suggests that the "actual notice" requirement is similar to the actual notice requirement under 35 USC §287(a) that the Federal Circuit has held requires that the patent owner provide an affirmative communication of a specific charge of infringement by a specific accused article or process. Therefore, it is unlikely that merely sending a copy of the published application, without more, would satisfy the actual notice requirement of the Act. Additionally, if the patentee is aware of a potential infringer, the patentee may file a petition to make special at the time of filing of the patent application to seek early examination of the application and prompt issuance of a patent, which potentially could occur before the eighteen month period for publication.

The fourth condition is that the right to obtain a reasonable royalty is only available if the infringement action is brought within six years after the patent is issued. This is consistent with 35 USC §286 that prevents the recovery of damages for any infringement that was committed more than six years prior to the filing of the claim for infringement. Since the provisional rights mature only when the patent issues, the ability to enforce these rights for six years is analogous to the right to obtain damages for a particular past act of infringement.

The Act's provision requiring the publication of U.S. patent applications is a significant departure from the prior law by changing the point in time for calculating the accrual of reasonable royalties. Although the effect of the law is tempered by requiring the issued claims to be substantially identical to the published claims, and by requiring actual notice under the Act, the accrual of damages beginning with publication provides significant new options for patentees to expand their patent enforcement and licensing programs.

VEDDER PRICE ADDS NEW IP LAWYER

MARK A. DALLA VALLE

Mark A. Dalla Valle, formerly a partner with the law firm of Wildman, Harrold, Allen & Dixon has joined the growing Intellectual Property practice as a Shareholder at Vedder Price.

Mr. Dalla Valle counsels clients in the field of patents, trademarks and copyrights, concentrating in serving technology clients, particularly those involved in the design, manufacture and sale of electronic devices, circuits and systems. He has written, filed and prosecuted hundreds of patents in many areas of technology including semiconductor fabrication and design, radio frequency circuits and systems, fiber optic signal processing, telecommunications circuits and systems, analog and digital circuits and systems, and computer hardware and software. He also provides validity and infringement opinions as well as the preparation and prosecution of trademark and copyright applications and technology licensing agreements.

An electrical engineering graduate of DeVry Institute of Technology (B.S.E.E.) and the University of Southern California (M.S.E.E.), Mark received his legal education at Loyola Law School (Los Angeles). Prior to entering into private practice, he worked for approximately ten years as a design engineer at Telease Technology and as a test engineer, design engineer and engineering manager at Hughes Aircraft Company.

Mr. Dalla Valle is licensed to practice in Illinois and California. He is admitted before the U. S. District Courts for the Northern, Central and Southern Districts of California as well as the U. S. Court of Appeals for the Ninth and Federal Circuits. Since 1990, he has been registered to practice before the U. S. Patent and Trademark Office.

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We welcome your suggestions for future articles. Please call Angelo J. Bufalino, the Intellectual Property and Technology Practice Chair at (312) 609-7850 with suggested topics, as well as other suggestions or comments concerning materials in this newsletter.

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About Vedder Price
Vedder Price is a national, full-service law firm with approximately 200 attorneys in Chicago, New York and Livingston, New Jersey.

Technology and Intellectual Property Group
Vedder, Price, Kaufman & Kammholz, P.C. offers its clients the benefits of a full-service patent, trademark and copyright law practice that is active in both domestic and foreign markets. Vedder Price's practice is directed not only at obtaining protection of intellectual property rights for its clients, but also at successfully enforcing such rights and defending its clients in the court and before federal agencies, such as the Patent and Trademark Office and the International Trade Commission when necessary.

We also have been principal counsel for both vendors and users of information technology products and services. Computer software development agreements, computer software licensing agreements, outsourcing (mainly of data management via specialized computer software tools, as well as help desk-type operations and networking operations), multimedia content acquisition agreements, security interests in intellectual property, distribution agreements and consulting agreements, creative business ventures and strategic alliances are all matters we handle regularly for our firm's client base.

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