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The M&A Tax Report

OCTOBER 2014 VOLUME 23, NUMBER 3

The Monthly Review of Taxes, Trends & Techniques

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Patents, Capital Gain and Inversions

By Rafi W. Mottahedeh • Wood LLP • San Francisco

Ask an individual if he or she would like ordinary income or long-term capital gain, and you can predict the response. But it turns out that not everyone prefers long-term capital gain. It does not matter to C corporations, which cannot benefit from the rate spread.

S corporations, LLCs and partnerships care, of course, as do individuals. A 20-percent tax on long-term capital gain is better than 39.6 percent, even if one must add to the former the 3.8-percent investment income tax introduced under President Obama as part of the controversial Affordable Care Act. As a result, even today, much of the planner's work is trying to qualify for capital gain. Unlike many other assets, patents can qualify for capital gain in several ways.

Using Code Sec. 1235

Code Sec. 1235 offers a special opportunity for some taxpayers owning patents to receive capital gain treatment upon sale. To qualify for capital gain under Code Sec. 1235, the person selling the patent must have either assisted in inventing the patent or purchased the patent from the inventor prior to it being turned into a usable and complete invention. The best part of Code Sec. 1235 is that, unlike virtually every other capital asset, no holding period is required to qualify for long-term capital gain.

Suppose a scientist creates and patents a compound, which, when added to raw rubber, makes car tires puncture-resistant. The scientist sells the invention to a tire research laboratory before developing a successful method to add it to mass-produced tires. Because the research lab purchased the patent to the compound before it was successfully reduced to practice, it can then sell the patent again and receive long-term capital gain treatment.

Another requirement for long-term capital gain treatment under Code Sec. 1235 is that the seller must transfer all substantial rights to a patent. The term "substantial rights" means all rights, whether or not held by the grantor, which are of value at the time of transfer.

Certain transfers of rights fail to qualify as the transfer of all “substantial rights,” including rights limited:

- (i) geographically to the country of issuance;
- (ii) by duration to a term that is less than the remaining life of the patent;
- (iii) by field of use to certain trades or industries; and
- (iv) to less than all the claims or inventions covered by the patent and that have value.

Notably, incomplete transfers can destroy the chance of ever receiving capital gain treatment upon the sale. If an inventor granted a broad license and then sold his or her patent to someone else, the buyer cannot purchase substantially all of the rights. The prior license defeats the ability to treat the second transaction as a sale.

In *D.R. Blake*, [CA-6, 80-1 USTC ¶9247, 615 F2d 731, cert. denied, SCt, 449 US 832, 101 SCt 102], the taxpayer was the owner of a patent

and granted a license agreement for certain uses to a licensee in one year. In a later year, the taxpayer transferred all of his remaining interest to a second licensee. The Sixth Circuit held that the second transfer did not qualify for capital gain treatment under Code Sec. 1235.

After all, the second transfer was subject to the license agreement in the first transfer. It therefore failed to qualify as a transfer of all “substantial rights” of the patent. If the inventor in *Blake* had known of this restriction, he probably would have declined to grant the first license.

Fortunately, substance controls—not form. Even if a transfer is mistakenly called a “license,” it can still qualify for capital gain treatment under Code Sec. 1235 if it is in substance a sale where all rights are transferred.

Using Code Secs. 1221 & 1231

Code Sec. 1221(a) defines a capital asset as property held by a taxpayer (whether or not connected to its trade or business), which is not within one of eight specific categories. In general, the two relevant categories for classifying patents as capital or ordinary are:

- (i) inventory or property held primarily for sale to customers in the ordinary course of trade or business (“inventory”); and
- (ii) property used in the taxpayer’s trade or business which is subject to the allowance for depreciation provided in Code Sec. 167. Patents generally qualify for the allowance for depreciation under Code Secs. 167 or 197, and depreciation under Code Sec. 197 will similarly result in the patent being used in the taxpayer’s trade or business.

Even though depreciable property used in a taxpayer’s trade or business generally does not qualify as a capital asset, gain from the sale of this type of property may still be treated as capital gain. Under Code Sec. 1231(a)(1), gain from the sale of certain types of depreciable property qualifies as capital gain.

Code Sec. 1231 property is defined as property satisfying three different requirements: (i) held for more than one year; (ii) used in the taxpayer’s trade or business; and (iii) subject to the allowance for depreciation under Code Sec. 167. Again, depreciation under Code Sec. 197 also qualifies. Of course, any depreciation taken is subject to recapture at ordinary rates before capital gain can kick in.



The M&A Tax Report
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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com. ©2014 CCH Incorporated. All Rights Reserved.

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Another caveat to keep in mind is that a professional inventor will have ordinary income on what essentially amounts to sales of inventory. Who is a professional inventor? It may sound like a question of degree, and to some extent it may be.

However, “professional inventor” is a term of art used in reference to persons who produce inventions for sale. The professional inventor’s business is inventing and documenting patents to sell to others, just as an automaker produces cars for sale. Yet the standards are fairly forgiving.

For example, in *P. Kucera* [10 TCM 303, Dec. 18,229(M) (1951)], the Tax Court held that an inventor with 21 inventions and several patents was not a professional. Although he was apparently an inveterate tinkerer, only one of his patents was ever sold and commercially viable. He had never been employed as an inventor, and the court held that as a nonprofessional, he was entitled to report his gain as capital.

In contrast, in *M.L. Lockhart* [CA-3, 58-2 USTC ¶9715, 258 F2d 343], the court considered an inventor who had a string of 37 patents over a 19-year period. He had an established pattern of developing patentable ideas in the medical field. He would interest a manufacturer in the idea, join the manufacturer and license or sell his patents to the manufacturer. In light of this pattern and the fact that the inventor had created 15 patents for basic inventions, the court considered him a professional inventor.

There are many shades of gray between the inventor in *Kucera* and the inventor in *Lockhart*. As with many facts-and-circumstances tests, the courts have failed to develop a uniform test for who is a professional inventor. In fact, some analogous areas of tax law can be fruitful sources of authority.

For example, the dichotomy between dealers and investors in real estate is a common source of authority. Although no one factor is controlling, the frequency and nature of sales activity is generally most important in determining whether a taxpayer is a professional inventor. Whether the inventor has a track record of success can also be key.

Royalties and Inversions

If one fails to meet the conditions for a transfer of patent rights to be considered a sale, the transfer

will instead be considered a license. Payments for patent rights under a license are royalties. Royalties are taxed as ordinary income.

Moving from closely held companies and inventors to big and diverse companies, however, inevitably means discussing C corporations. As noted at the outset, C corporations do not benefit from a capital gain rate differential. In fact, C corporations get the worst of both worlds. Even though they get no preferential rate for capital gains, they still cannot net capital gains or losses with ordinary gains or losses.

Plainly, a nascent inventor should almost never create a C corporation to own his or her inventions. But public companies are different, and one of the latest trends roiling them is inversions. Even if a U.S. company’s French subsidiary is licensing a patent to an entity in Japan, the U.S. company must pay U.S. tax on the royalty income.

Inversions are popular because the corporation at the top of a chain is no longer in the United States, and therefore not saddled with U.S. taxes on its worldwide income. But an inversion is not a panacea when dealing with patents. To successfully (and legally) avoid U.S. taxes on a patent requires planning.

In some cases, significant time is needed before a company can receive the maximum benefit. With the U.S. tax system becoming less competitive compared to the rest of the industrialized world, companies want to move overseas. Nevertheless, it is not as simple as moving offices and incorporating somewhere else. That trick was quickly put to an end when Stanley Works, the iconic American maker of hammers and screwdrivers, decided to decamp to Bermuda in 2002.

Outcry and anger that an American icon would depart so quickly put an end to Stanley’s plans, but Congress went a step further and decided to act. Agreeing that an absolute bar on moving overseas was impractical, Congress passed legislation allowing companies to escape the United States tax-free only for the legitimate reason of a merger.

As companies search for willing foreign suitors, the mix of attributes can be debated. Yet even merging with a small or unsuccessful rival may make good sense when the tax

savings are taken into account. The desired merger partner may not even have to be in a low-tax jurisdiction or tax haven. After all, the newly minted entity formed from the merger can be put in favorable tax jurisdiction.

For example, merger partners may get creative in the kitchen with a Double Irish, Dutch Sandwich or both. Plainly, a Double Irish with a Dutch Sandwich isn't something edible. Yet they remain palatable for investors looking for tax efficiency. Tokyo Electron's merger with Applied Materials will result in a new company, domiciled in the Netherlands—even though neither Tokyo Electron nor Applied Materials is Dutch.

Moving Patents

Although an inversion may be capable of solving some architectural tax woes, it is unlikely to solve all of them. By definition, the hydra that the U.S. tax code has become will remain. For example, Code Sec. 367 allows for mergers with foreign companies and other overseas reorganizations, albeit with less flexibility than a domestic merger or reorganization.

However, Code Sec. 367(d) prevents patents from receiving even the somewhat favorable treatment allowed for international mergers and re-organizations. In fact, Code Sec. 367(d) requires that if a patent is transferred to a foreign corporation in a tax-free reorganization (including an inversion), the U.S. corporation which transfers the patent is treated as selling the patent. But it isn't just *any* sale.

The U.S. corporation is treated as selling the patent for a contingent set of annual payments which equal what it would have received if it had stayed in the United States. This is a fancy way of saying that there is virtually no escape for a patent. Furthermore, even a sale by the foreign corporation to another, unrelated foreign corporation will still be treated as gain subject to U.S. taxes.

What does this mean? The answer is highly fact-dependent. But it seems safe to say that the tax benefits available to the raft of pharmaceutical companies pursuing inversion transactions may in some cases not

be as great as public outcry might suggest. After all, what about all those patents stuck in the United States?

With that, and with the transfer pricing rules offering an additional backup to Code Sec. 367(d), the web of U.S. taxes can be sticky and as hard to escape as an intricate spider web.

Go Foreign, Young Man

U.S. companies that desire to steer clear of what can feel like a never-ending net of U.S. taxation are often looking over the horizon. Patents that are situated overseas can be more valuable. If a French subsidiary owns a patent, as opposed to its U.S. parent, it has some avenues to escape U.S. taxation—even in the event of an inversion by its U.S. parent.

Still, like so much else, the devil is in the details. Not only must the patent be situated overseas, but the efforts which go into inventing the patent must also have been truly foreign. Transfer pricing has an ugly way of determining whether a patent is at least partially in the U.S. tax net. Moreover, it can be hard to imagine many major companies wishing to completely forego any research and development in the United States.

Easier Sold Than Done?

Naturally, companies such as Abbott Laboratories are in business to do more than sell patents. However, for a small company or an individual inventor, it may be easier to sell a patent than have it rooted permanently in the complicated webbing of U.S. taxation. Key decisions may include whether to grant licenses or simply sell a patent, what type of entity will own the patent and where the patent will be developed.

For the nonprofessional inventor and for flow-through entities, such as S corporations and LLCs, the sale should qualify for long-term capital gain treatment. That isn't half bad. Besides, a sale can tidily tie up what can otherwise seem to be an all-encompassing U.S. tax net, which even an inversion cannot completely escape.