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Tax Planning Opportunities for Creators of Medical Technology

by

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With the exception of a brief period during the late 1980's, capital gains have been taxed at a lower rate than ordinary income since 1921. Currently, the federal tax rate applicable to long-term capital gain is 15%, which is substantially lower than the highest individual federal income tax rate of 35%. Consequently, the distinction between ordinary income and capital gain is of importance to most, if not all, taxpayers.

In making the distinction between ordinary income and capital gain, taxpayers and tax practitioners alike often overlook the preferential tax treatment accorded to transfers of certain intellectual property. For instance, under Section 1235(a) of the Internal Revenue Code[1], amounts received from the sale or exchange of all substantial rights to a patent are treated as long-term capital gain. Likewise, payments received in exchange for know-how and trade secrets qualify for capital gain treatment, provided that the taxpayer transfers all substantial rights in the information and is not a professional developer of intellectual property.

As a result of the rapid pace of technological and other advances in the medical field, medical professionals should be not only aware of the tax consequences of transferring intellectual property, but cognizant of how to best structure such transfers to qualify for capital gain treatment. This article will summarize the tax consequences associated with transfers of patents, know-how, and trade secrets and how such transfers can be structured to qualify for capital gain treatment.

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A. Qualifying Transfers of Patents and Patent Rights for Capital Gain Treatment

Section 1235(a) treats payments received from the sale or exchange of "all substantial rights" to a patent as long-term capital gain. Section 1235(a) provides, in pertinent part:

> *A transfer … of property consisting of all substantial rights to a patent … by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year …*

The tax treatment accorded to transfers of patents and patent rights is particularly favorable. First, unlike most assets qualifying for capital gain treatment, a patent does not need to be held for more than one year to qualify for long-term capital gain treatment (i.e., the preferential 15% rate). Second, professional developers of patentable property (who often are precluded from claiming long-term capital gain treatment on the sale or exchange of other property) are eligible for capital gain treatment on the sale or exchange of a patent. In addition, the Treasury Regulations define the term "patent" broadly to include patents as well as patentable property, regardless of whether a formal patent application has been filed. Consequently, long-term capital gain treatment also applies to the sale or exchange of patent *rights*. The only requirement is that the transferred property be patentable at the time of the transfer.

1. Taxpayer Must Transfer "All Substantial Rights"

As indicated above, long-term capital gain treatment under Section 1235(a) only applies to a transfer of property consisting of "*all substantial rights*" to a patent. According to Treasury Regulation § 1.1235-2(b)(1), all substantial rights to a patent are *not* transferred if the transfer.

> *"...in order to qualify for capital gain treatment, the asset being transferred (i.e., the know-how or trade secret) must be a capital asset. To qualify as a capital asset, the item being sold or exchanged must be 'property.' "*

- Is limited geographically within the country of issuance; or
- Is limited in duration by the terms of the agreement to a period less than the remaining life of the patent.
- Grants rights to the grantee, in fields of use within trades or industries, which are *less* than all the rights covered by the patent, which exist or have value at the time of the grant; or
- Grants to the grantee *less* than all of the claims or inventions covered by the patent which exist and have value at the time of the grant.

Accordingly, taxpayers need to take care when placing limitations on the transferee's ability to use and exploit the transferred patent rights if they want the transfer to qualify for capital gain treatment.

2. Taxpayer Must Be the Original or Joint Inventor

To qualify for long-term capital gain treatment under Section 1235(a), the transfer of patent rights also must be made by the "holder" of the patent. Treasury Regulation § 1.1235-2(d)(1) defines the term "holder" as:

> *[A]ny individual... [w]hose efforts created the patent property and who would qualify as the "original and first" inventor, or joint inventor...*

While at first blush this requirement appears rather innocuous, it has been used by the Internal Revenue Service (the "IRS") to deny capital gain treatment when the transfer of patent rights occurs in the employment context. If the payments received on the transfer are part of an employment arrangement, the transfer will not qualify for capital gain treatment. However, if it is determined that the payments truly are attributable to the transfer of patent rights, and, if all of the other requirements under Section 1235 are met, the payments will be treated as derived from the sale of a patent.

To recap, long-term capital gain treatment under Section 1235(a) applies to transfers of "property consisting of all substantial rights to a patent," regardless of whether the holder of the patent held the patent for more than a year. However, taxpayers must take care to structure the transaction so as to transfer all of the substantial rights to the patent. Likewise, transfers made in the employment context should be closely scrutinized.

B. Qualifying Transfers of "Know-How" and "Trade Secrets" for Capital Gain Treatment

The Internal Revenue Code does not deal specifically with the sale or exchange of "know-how" or "trade secrets." In fact, the terms "know-how" and "trade secret" are not defined in either the Internal Revenue Code or the Treasury Regulations. As a result, a determination of whether a transfer of "know-how" or "trade secrets" qualifies for capital gain treatment must be made according to general federal tax principles.

First, in order to qualify for capital gain treatment, the asset being transferred (i.e., the know-how or trade secret) must be a capital asset. To qualify as a capital asset, the item being sold or exchanged must be "property." Although the terms "know-how" and "trade secret" are not defined in the Internal Revenue Code or the Treasury Regulations, the IRS and the courts have consistently held that know-how and trade secrets qualify as "property."

For instance, in Revenue Ruling 55-17, 1971-2 C.B. 179, the IRS held that the term "property" includes anything qualifying as "secret processes and formulas." Likewise, in the seminal case of *DuPont v. United States*, 288 F.2d 904, 910 (Ct. Cl. 1961), the Court of Claims adopted a secrecy requirement in defining a "trade secret" as "property," stating:

> *[A] trade secret, as a tool for commercial competition, derives much of its value from the fact of its secrecy. It is truly valuable only so long as it is a secret ... It follows that the essential element of a trade secret ... which distinguishes it from other forms of ideas is the right in the discoverer to prevent unauthorized disclosure ...*

Because the IRS and the courts both view know-how and trade secrets as "property" for tax federal purposes, know-how and trade secrets can qualify as capital assets.

1. Restriction on Professional Developers

Although transfers of know-how and trade secrets can qualify for capital gain treatment, the transfer will not qualify for such treatment if the transferor is a professional developer of know-how or trade secrets. In the case of professional developers, the transferred information likely will be treated as "stock in trade" or property held "for sale to customers," both of which are excluded from the definition of a "capital asset" in Section 1221(a).

2. Taxpayers Must Meet a Holding Period Requirement

Whether the gain on the sale or exchange of know-how or trade secrets is characterized as long-term capital gain (i.e., held for more than one year) or short-term capital gain (i.e., held for a year or less) depends on the transferor's holding period. A transferor's holding period commences on the purchase of the know-how or the date when developed know-how is reduced to practice (i.e., a demonstration that the invented concept or idea works).

Nonetheless, where the transfer of know-how or trade secrets is ancillary to the transfer of other property (such as patents), and where the other property satisfies the long-term holding period requirement, the know-how or trade secret likely will also satisfy the long-term holding period requirement. As a result, know-how or trade secrets transferred along with a patent likely will qualify for long-term capital gain treatment by virtue of the fact that the patent qualifies for such treatment under Section 1235(a).

3. Taxpayer Must Transfer "All Substantial Rights"

As with the sale of patents under Section 1235(a), the IRS requires taxpayers to transfer "all substantial rights" (as defined in Section 1235(a)) in the know-how or trade secrets in order for the transfer to qualify for capital gain treatment. With respect to this requirement, the transferor also needs to transfer right to prevent the unauthorized disclosure in order to transfer "all substantial rights" in know-how or trade secrets.

4. Performance of Services in Connection With the Transfer of Know-How and Trade Secrets

As previously discussed, payments received for the performance of services are not accorded capital gain treatment. Rather, such payments are treated as ordinary income. As a result, when services are associated with the transfer of know-how or trade secrets, the transfer may not qualify for capital gain treatment.

In sum, transfers or know-how and trade secrets qualify for long-term capital gain treatment if the transferor (i) transfers all substantial rights; (ii) is not a professional developer; (iii) satisfies the holding period requirement; and (iv) the consideration is not received in exchange for the transferor's services.

C. Conclusion

Due to the favorable tax rate currently applicable to long-term capital gain, taxpayers should be aware of the ways in which transfers of certain intellectual property can be structured to qualify for long-term capital gain treatment. In particular, in fields like medicine and biotechnology, where new advances and technologies are constantly under development, tax planning with respect to a possible transfer of medical technology is critical and should be undertaken early in the development process.

[1] *Unless indicated otherwise, all section references herein are to the Internal Revenue Code of 1986, as amended.*

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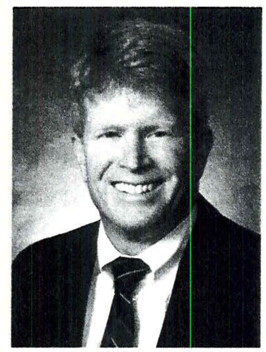

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