

TRANSFEROR'S TAX TREATMENT ON INCOME RECEIVED: CAPITAL GAIN OR ORDINARY INCOME

Introduction

Specific intellectual properties with which we will be concerned include patents, patent applications, trade secrets and know-how, trademarks, trade names and copyrights.

Generally, a primary goal of the seller is to structure the transfer so that the money received is taxed at the lower, long-term capital gain rate.

However, to achieve this goal, the seller will often have to give something up. For example, there may be important commercial advantages if the licensor restricts the license in ways that preclude long-term capital gain treatment, gives only a nonexclusive license, or transfers rights to a party having a relationship to the seller that precludes capital gain treatment.

Thus, your inquiry is not simply whether the sale can qualify for capital gain treatment, but additionally, if the savings realized by qualifying for capital gain treatment (as compared with ordinary income treatment) justifies relinquishing these commercial advantages.

There are two distinct ways to qualify for long-term capital gain treatment.

First, there is Section 1235.* This section applies only to patentable inventions.

Second, there is the regular capital gain Section 1221. This section applies to all properties including patentable inventions as well as the other properties which I mentioned, trade secrets, know-how, trademarks, trade names and copyrights.

It is important to understand both of these sections since the regular capital gain Section 1221 will probably be applicable more often than the special patent Section 1235.

Section 1235

Qualifying Properties—What properties qualify for treatment under this section? The answer is patentable inventions, whether patented, pending or not yet filed. Consequently, if doubts as to patentability exist, it is advisable to conduct a patentability search to confirm that the invention constitutes patentable subject matter.

While it is not necessary that a patent application has been filed, it is necessary that the invention has been actually reduced to practice; or just conceived, if it appears that it is capable of either actual or constructive reduction to practice.

Foreign patents, design patents and plant patents are also included in Section 1235.

Although my comments suggest that the property must at least be conceived, there is one exception to this rule. If a license transferring existing rights also transfers the rights to future improvements, then payments for those future improvements will qualify under Section 1235. A case in point is *Thomas L. Fawick v. Commissioner*, 52 TC 104, 162 USPQ 185

* Section references are to the Internal Revenue Code of 1954, as amended (26 U.S.C.), unless otherwise indicated.

(Tax Court 1969).

The Holding Period—How long must the property be held by the transferor before it is sold? The answer is that there is no holding period at all, and this is the primary benefit of Section 1235. By contrast, as you are of course aware, under the regular capital gains Section 1221, there is a one year holding period.

Holder Status—Which sellers qualify under Section 1235? The seller must be a "holder." Who qualifies as a holder? First, of course, the inventor. Second, an individual investor who acquired his interest from the inventor prior to actual reduction to practice. The test for actual reduction to practice is the same as in a Patent and Trademark Office Interference proceeding; and in fact the Treasury regulations (26 C.F.R. §1.1235) refer to 35 U.S.C. 102(g) as the test. Therefore, if your client is an investor, one of your first inquiries is whether the invention that he is about to purchase has been actually reduced to practice.

This individual investor cannot be a holder if he is the employer of the inventor or if he is related to the inventor. (I will discuss this concept of "related" in greater detail below.)

What about a partnership? If the patent rights are transferred to a partnership, can the partnership qualify as a holder? Although the partnership is not an individual, and hence cannot itself qualify as a holder, its individual partners will be considered as holders. In fact, if some of the partners are individuals and other partners are not, then the individual partners will still be entitled to the status of "holder."

Finally, one is not disqualified from being a holder if he is in the trade or business of selling patents. This is the second major benefit of Section 1235 since such a person would not qualify for long-term capital gain treatment under Section 1221.

I shall digress briefly for an "editorial." If the purpose of Section 1235 is to promote R&D and innovation in general, why should this Section be limited to individuals? Why not universities? Why not small businesses which conduct R&D?

Concerning universities, assume that an investor approaches a university and offers a million dollars to conduct R&D, in return for title to the technology developed. Although the university might indeed wish to accept this offer, it would probably have an agreement with its R&D personnel to assign all rights to the university, meaning that the rights would have to pass from the inventor, through the university to the investor. This would preclude the investor from being a holder under Section 1235.

Many small businesses are often the alter ego of the inventor, or substantially so. It seems illogical that just because the inventor assigns his invention to his company, that his company cannot be a holder under Section 1235 when it tries to sell the invention to others.

Legislation was introduced in Congress last year that would have included a university under the definition of "holder." Unfortunately, this legislation died at the end of the last Congress, and it is uncertain whether it will be reintroduced.

Type of Transferee Under §1235—The transferee

cannot be related to the transferor. There are three types of relationships that preclude capital gain treatment under Section 1235. First, a family member. The transferee cannot be the spouse, ancestral or lineal descendant of the transferor. You might note that this is more liberal than other IRS Sections that define family to include siblings.

Second, 1235 does not apply to transfers to a corporation of which the holder owns 25% or more of the value of the stock. (Note that the test is value, not voting percentage. Therefore, an inventor can maintain control by having different classes of stock). Also, note that there is no restriction here preventing a transfer to an unincorporated sole proprietorship or to a partnership. However, in the case of a partnership, there are other restrictions under Section 707. Basically, Section 707 precludes capital gain treatment for certain properties where the partner-transferor, owns 80% or more of the partnership.

Third, Section 1235 does not apply to transfers between certain parties related through a trust or through tax exempt charitable organizations.

What about the employer of the transferor/holder. There is no restriction against the holder selling to his employer and benefiting under Section 1235.

To avoid confusion, I stated above that an employer of the inventor, who purchased from the inventor, could not qualify as a holder when that employer resells the patent rights. I also stated that a partnership (as distinguished from its partners) could not be a holder. However, we are now discussing the altogether different question of whether one who has already established holder status (that is, an inventor or an investor) can benefit from Section 1235 on the sale to his employer or to a partnership.)

Although a sale to a holder's employer can qualify under Section 1235, it will not qualify if the money paid to the holder appears to be compensation for services rather than a sale of patent rights.

If the employer/holder has a contract requiring automatic transfer of all patent rights to the employer, then any money paid to that holder will always be considered to be for services, and Section 1235 will be inapplicable.

All Substantial Rights—A general principle of tax law is that capital gains treatment is available only for the transfer of title to property, while ordinary income treatment applies for the granting of a right to use the property, which right does not involve a transfer of title. None of the numerous laws, regulations and cases dealing with "all substantial rights" have altered this general principle. Rather, their purpose has been to adapt that general principle to the realities of licensing situations.

Therefore, before and after analyzing the specific guidelines that I will discuss in a moment, one basic question should be asked: Considering the transfer as a whole, has the license transferred all rights which are of value at the time of the transfer (including an undivided interest of all substantial rights)?

The IRS regulations (26 C.F.R. §1.1235-2) set forth five types of restrictions that are not permissible under Section 1235, two types that are permissible, and two other types that are stated to be borderline situations.

The five types of not-permissible restrictions—those that will result in a holding that the transfer is not of "all substantial rights"—includes the following:

1. Geographic limitations.
2. Limitations to less than the remaining life of the patent.
3. Limitations of the field of use to less than all fields that have value at the time of the grant.
4. Limitations to less than all claims which have value at the time of the grant.
5. A right by the licensor to terminate at will.

The following two types of restrictions are permitted, that is, they will not preclude capital gain treatment under Section 1235:

1. Retention of title by the licensor to secure performance.
2. Retention of a security interest and a right to a reversion of title back to the licensor upon a condition subsequent, for example, nonperformance.

The two borderline types of restrictions include the following. First, a prohibition against the licensee further sub-licensing or assigning. Second, granting the right to "make" but retaining the right to use or to sell.

If these borderline restrictions exist, IRS will examine the "circumstances of the whole transaction" to ascertain whether or not there has been a transfer of "all substantial rights."

As a general observation, restrictions relating to the transferee's right to further license or sell, or to bring an infringement action, will not preclude capital gain treatment under Section 1235, unless they are combined with numerous other restrictions.

Imputed Interest—Under Section 483 of the IRS Code, in any sale of any kind for which some payments are due beyond the year of the transfer, a portion of those future payments will be treated as interest, and hence, taxable as ordinary income. However, Section 483 specifically exempts transfers under Section 1235. This exemption does not apply to transfers under Section 1221. This is, therefore, the third important benefit of Section 1235, as compared to Section 1221.

Sections 1221/1231

Let's turn to the regular capital gain Section, 1221. By "regular" I refer to the main capital gain Section of the IRS Code that applies to the gain on all capital properties such as on the sale of stocks or bonds, real property, etc.

Qualifying Properties—First, which intellectual properties qualify for treatment under Section 1221?

The general heading of Section 1221 encompasses all intellectual properties. Sub-parts of Section 1221 and other sections of the code then erode the broad sweep of the heading.

Let's follow that same format by first listing all properties encompassed by the heading and then examining how various sections of the code limit the applicability of Section 1221.

- (1) Patent and allowed Appln. (Deprec.-Section 167)
- (2) Patent Appln. prior to Allowance
- (3) Invention, Application not yet filed
- (4) Trade Secret, Patentable Subject Matter

- (5) Trade Secret, Non-Patentable Subject Matter
- (6) Trademark, Trade Name
- (7) Copyright (Deprec. - Section 167)

Note that the first and last items in the list, patents and copyrights, are indicated as being depreciable assets under Section 167. The remaining five items have an indefinite life, and hence are not depreciable assets. This distinction has significance in the discussion to follow.

The first limitation (found in Section 1221(1)) is that none of these properties can be a capital asset if, in the hands of the transferor, it is inventory, i.e. stock in trade. That limitation is absolute. All money received for such sales constitute ordinary income. Hence, for a person in the business of buying and selling patents, Section 1235 is the only possibility for capital gain treatment.

The second limitation is that these properties cannot qualify as a capital asset if they are used in the transferor's trade or business, and are depreciable property under Section 167.

This limitation, which is found in Section 1221(2), would disqualify the first and last items in the list, patents and copyrights. However, Section 1231 effectively reinstates patents, if the patents are not held "primarily for sale to customers in the ordinary course of business." Note that this is different, more restrictive than "inventory," which constitutes "stock in trade." For example, a company that is in the business of conducting R&D to develop patentable inventions and then selling those inventions might be subject to this limitation even though the patents are not "stock in trade." This issue also arises in the case of R&D limited partnerships that are set up essentially to provide money for R&D, purchase the resulting technology, and then resell the resulting technology. However, for a number of reasons, it is possible to conclude that R.D.L.P.'s are not holding the technology primarily for sale to customers "in the ordinary course" of its business.

Third Limitation

The third limitation relates to copyrights. Under Section 1221(3), the sale of a copyright by the creator of the copyright cannot constitute a capital gain. This is the "Eisenhower Amendment" that was passed after General Eisenhower made a substantial profit by selling his book and having the income treated as a capital gain.

The fourth limitation concerns trademarks and trade names. Section 1253(a) precludes capital gain treatment for any exclusive license where the transferor maintains any significant power. And 1253(c) does the same whenever amounts received by the transferor are contingent on use of the mark. Since significant power will always be retained and/or payment will usually be contingent, in the case of a true trademark license, the conclusion is that unless the trademark is sold outright, the money received will be ordinary income.

Holding Period—It is one year from the date of purchase of the asset; or in the case of a developed asset, one year from the date of actual reduction to practice or the issuance of the patent, whichever comes first.

Limitations on Transferor—There are none. Anyone, or any legal entity that can own property can qualify as a transferor. Stated differently, there are no restrictions similar to the "holder" requirements of Section 1235.

Limitations on Transferee—Sections 707 and 1249 preclude capital gain treatment on a sale to a controlled partnership or a controlled foreign corporation, respectively.

Of more general interest is Section 1239, which precludes capital gain treatment where the following two conditions exist: First, the property is a depreciable property under Section 167, and second, the transferor and transferee are related. "Relationship" in this case includes (1) husband and wife, (2) an individual and a corporation of which the individual owns 80% or more of the value of the stock, and (3) two corporations, each 80% owned by the same individual.

You will observe that the Section 1239 limitation applies only to depreciable properties. Therefore, if your client is an individual inventor and owns 100% of his corporation, he can license or assign his invention to the corporation if it is not yet a patent application or if it is a patent application, but has not yet been allowed, provided the one year holding period has been satisfied, and he can obtain long-term capital gain treatment. A case in point is *Lan Jen Chu v. Commissioner*, 486 F.2d 696 (1st Cir. 1973). This treatment remains in effect even after the patent is allowed, issued, and becomes a depreciable asset in the hands of the corporation.

All Substantial Rights—Finally, the transfer must be of all substantial rights. With respect to patents, patent applications and unfiled patentable inventions, we may state as a general rule that the guidelines discussed above with respect to Section 1235 also apply to the transfer of these properties under Section 1221.

However, there are important departures from this general observation. The guidelines discussed earlier in connection with 1235 were taken from the treasury regulations which apply specifically to Section 1235. No similar regulations are found under Sections 1221 or 1231. Therefore, there is a rationale for allowing greater license restrictions under 1221/1231 than under 1235.

In fact, cases have permitted greater license restrictions under 1221. These include the following:

1. A limitation on scope to less than all of the claims has been upheld by several courts, as not disqualifying the transaction from capital gain treatment. In these cases it is necessary to show that the claims are directed to separate and identifiable inventions. This ability to have greater restrictions on scope was upheld in 1970 by the Third Circuit in *Dupont v. U.S.*, 432 F.2d 1052 as well as another Third Circuit case and a Court of Claims case.

2. Geographic limitations were upheld in a Tax Court case. See *MacDonald v. Commissioner*, 55 T.C. 840, 170 U.S.P.Q. 133 (Tax Court 1971). We might also observe that Section 261 of Title 35 allows an assignment "to the whole or any specific part of the United States."

3. Field-of-use restrictions have also been held proper by the Tax Court. See *Laurent et al v. Commissioner*, 34 T.C. 385, 125 U.S.P.Q. 601 (Tax Court 1960).

In the case of trade secrets, a transfer of "all substantial rights" must include the entire right to use, exclusive of the transferor, and the right to prevent unauthorized disclosure of the secret.

In addition, to qualify for capital gain treatment, the trade secret must be transferred in perpetuity (since it has no definite life) and it must be granted for an entire country. The IRS has issued a Revenue Ruling dealing with trade secrets, namely R.R. 64-56, 1964-1 C.B. 133.

TRANSFEREE'S TAX DEDUCTION OF AMOUNTS PAID TO TECHNOLOGY: AMORTIZATION AND/OR DEPRECIATION

These properties; that is, inventions (whether patentable or maintained as a trade secret), trade names, trademarks and copyrights are capital assets.

The general rule is: that amounts spent to purchase a capital property are deducted gradually, a portion each year, that is, depreciated or amortized over the useful life of the property.

Following these general rules: Amounts spent to purchase a newly issued patent would be deducted gradually over the 17-year life of the patent, and amounts spent to purchase a trademark, trade name or trade secret can never be deducted because these properties have an indefinite life that is treated as an *infinite* life.

I have two caveats before going forward.

First, since we are concerned here with the *purchase of existing rights*, the special R&D expensing Section 174 is not applicable and the special five-year trademark amortization Section 177 is not applicable.

Second, since these intellectual properties—inventions, trade secrets, trademarks, copyrights and the like—are intangible properties, the much-heralded accelerated cost recovery system of the 1981 act does not apply. Rather, tax treatment of these properties is covered by Section 167 and the pre-1981 depreciation laws.

Returning now to our main theme, the good news is that the general rule mentioned above can frequently be avoided in favor of more rapid deduction of the amounts spent to purchase the property.

Purchase of Issued Patent

First, consider such a purchase by one who is in the business of buying and selling patents. For this person the patents are not capital assets. Depreciation is not applicable. The patents are simply stock in trade, i.e. inventory. The purchase costs are simply offset against the income derived from the sale of the patents.

Second, and certainly the most important type of purchaser is one who buys a patent for use in his trade or business. Also included in this category is the individual who purchases a patent for the production of income.

For this type of purchaser, the patent is a capital asset. Therefore, applying the general rule, the purchase costs must be capitalized and depreciated over the remaining life of the patent.

However, there are four ways to write off the purchase costs over a shorter time.

1. The variable contingent payment method. If the sales price is an amount paid each year that is contingent on subsequent events, such as a percentage of sales of the patented item, then the amount paid each year can be deducted as the depreciation deduction in that year. This is covered by Rev. Ruling 67-136, 1967-1 C.B. 58.

2. The income forecast method. If it can be shown that the patent will produce income over a certain period of years, the purchase cost can be written off over that time frame. Rev. Ruling 79-85 covers this method, 1979-2 C.B. 91.

3. Abnormal obsolescence. If it can be shown that abnormal obsolescence will shorten the life of the patent, then the purchase costs can be written off over that shortened period.

4. Where the taxpayer purchases a group of patents and cannot allocate the cost to specific patents of the group, the taxpayer can deduct the cost over either (1) the average life of the patents or (2) the life of a basic patent of the group.

Next, consider the case of a mere license, that is, a transaction which is clearly *not* a purchase of all substantial rights. If the taxpayer merely takes such a license, the costs, that is, the royalties, are always currently deductible as an ordinary business expense.

PATENT APPLICATION OR TRADE SECRET

Basically, the rules here are similar to those discussed above for an issued patent. However, since these properties have no determinable limited life, if we apply the general rule discussed above, these costs cannot be deducted at all, but must remain on the company's books indefinitely, until the company is sold or dissolved, the asset is sold or until the asset becomes worthless.

Therefore, it is even more important in the case of these assets of indeterminate life to apply one of the methods mentioned above to shorten the time frame over which the purchase costs can be deducted.

And there is of course a fifth method. In the case of a patent application, when the application becomes an issued patent, the purchase costs, together with any subsequent prosecution costs are added together and become the cost basis of the issued patent. These costs are then depreciated at most over the life of the patent, but preferably over a shorter time as discussed above in the case of an issued patent.

Purchase of Trademarks or Trade Names

For tax purposes trademarks, trade names and goodwill are defined as capital assets of indefinite life and hence not subject to depreciation.

Outright Purchase—If a trademark is purchased outright (that is, the seller retains no control) regardless of the method of payment the purchaser cannot ever deduct that amount unless the trademark becomes a loss by abandonment of the mark. If such loss or sale occurs, the purchaser can deduct all purchase costs in the year of the loss or sale.

Therefore, if your client purchases a trademark along

with other assets—which are depreciable—try to apply as much as possible of the total purchase price to the depreciable assets, and as little as possible to the trademark, or trade name.

Retention of Rights by Seller—Let's consider the tax treatment of purchase costs where the seller has retained significant rights. This of course would cover virtually any valid trademark license.

For such purchases of a trademark or trade name, Section 1253(d) eliminates the harsh results that occur in the case of an outright purchase, i.e. total nondeductibility.

Under Section 1253(d)(1), if payments are contingent on events such as productivity or use of the trademark or trade name, then such payments can all be deducted in the year made.

Under 1253(d)(2), if the payments are *not contingent*, but the seller has retained any significant rights (as must exist in the case of a license) the purchaser can deduct the payments over an extended time, basically over 10 years as opposed to not deducting the payments at all.

Copyrights

In the copyright area, we must distinguish between three properties.

First, the pure intangible copyright.

Second, the tangible master of the work, including for example, a book manuscript, a film negative or master sound recording.

Third, multiple copies of the work to be sold to the public.

Let me initially take up this third property, just briefly, and then dismiss it. Multiple copies are in reality stock in trade and the costs of producing them are ordinary business expenses.

The Pure Copyright—The legal copyright is an intangible, depreciable property. Therefore, the purchase cost cannot be currently deducted, but must be depreciated. Since copyrights, like patents, are intangible properties, they are deducted under the conventional pre-1981 Section 167 depreciation laws, and not the accelerated-cost recovery system.

Now, over what useful life can the copyright be deducted.

The general rule is that the costs would be deducted over the legal life of the copyright. However, under the old or the new Copyright Act, this is too long and too uncertain.

As a result, most copyright purchase costs end up being deducted over a shorter time in accordance with one of the following two methods.

The first is the variable-contingent payment rule. As with patents, if a copyright is purchased for an amount dependent on subsequent events (such as a percentage of sales under the copyright) then the purchaser may deduct the amount paid each year as the depreciation deduction for that year.

Second, if the purchaser can show that the copyright has a shorter useful life to him in his business, then he can deduct the purchase cost over that shorter life.

And, as with patents and trademarks, if the copyright becomes worthless or is abandoned, all costs can be deducted in the year that the loss occurs.

Copyright Plus Tangible Master—Next, the purchase of a copyright along with the tangible master expression of the work.

The Internal Revenue Service currently treats this group of rights as an intangible property. However, realizing that it is in reality a hybrid of tangible and intangible properties, they have established a special, relatively favorable method for deducting these purchase costs.

This is the income forecast method (also known as the flow of income method). The formula is somewhat complicated. But basically, the purchaser estimates the years over which the purchased rights will produce income, and then deducts the purchase cost over that time frame. This is explained in Rev. Ruling 60-358, 1960-2 C.B. 68.

An important question that arises is whether the taxpayer can separate out the "pure legal copyright" from the work itself.

If the answer is "yes," then the work clearly becomes tangible property, and can benefit from the following advantages. First, the purchase costs are deductible over five years under the accelerated-cost recovery system of the 1981 Act. Second, a portion of these costs can be expensed under a new Section 179 of the 1981 act. Third, the costs are subject to an investment tax credit.

I have suggested advantages if the "pure legal copyright" can be separated from the work itself. However, the law is now very unclear as to whether or not this can be done.

Mere License—And finally, as in the case of patents and trademarks, the costs to purchase a mere, nonexclusive license, i.e. the royalty payments, are currently deductible as ordinary business expenses.

TYPICAL SITUATIONS— AFTER-TAX ANALYSIS

By way of summary, we first discussed the treatment of money received by the seller, and in particular whether such amounts were ordinary income or long-term capital gain. Simplifying the matter, payments to IRS reduce the amount retained by the seller.

We then covered the buyers tax deduction for the amounts that he pays to the seller. Such deductions are of course a benefit because it means that in reality the government has contributed a portion of the buyer's payment to the seller. This contribution reduces the effective amount paid to the seller resulting in a lower "net cost."

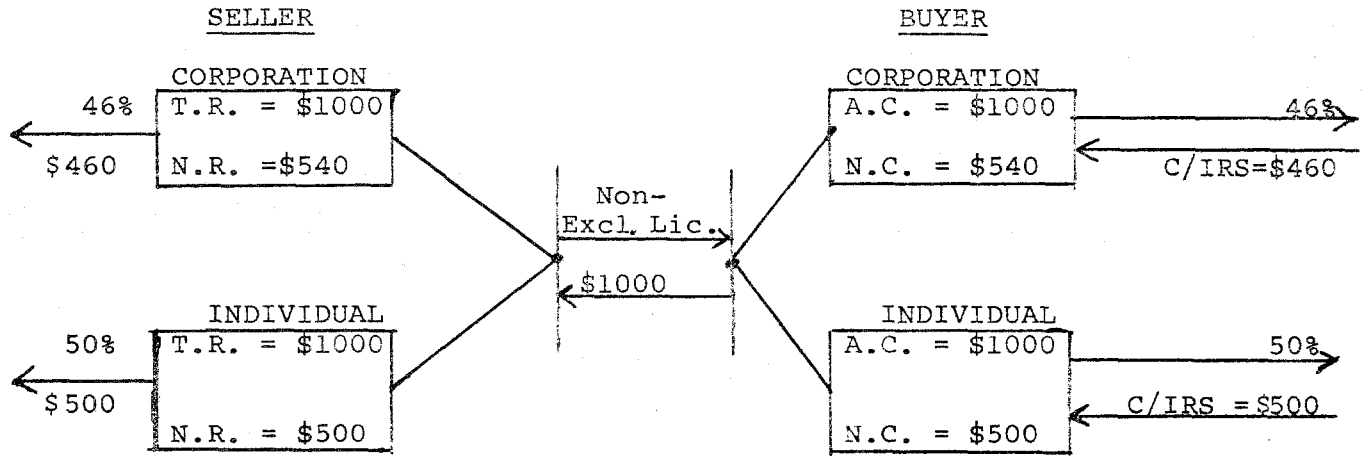
The following examples illustrate the impact of taxes in some typical licensing situations.

For simplicity, in these examples it is assumed that individuals are in the 50% tax bracket (with a maximum long term capital gain rate of 20%) and that corporations are in the highest corporate tax bracket, 46%, (and subject to the maximum corporate long-term capital gain rate of 28%).

Example No. 1 relates to a nonexclusive patent license. The chart illustrates the after-tax consequences for each \$1,000 of royalty payments.

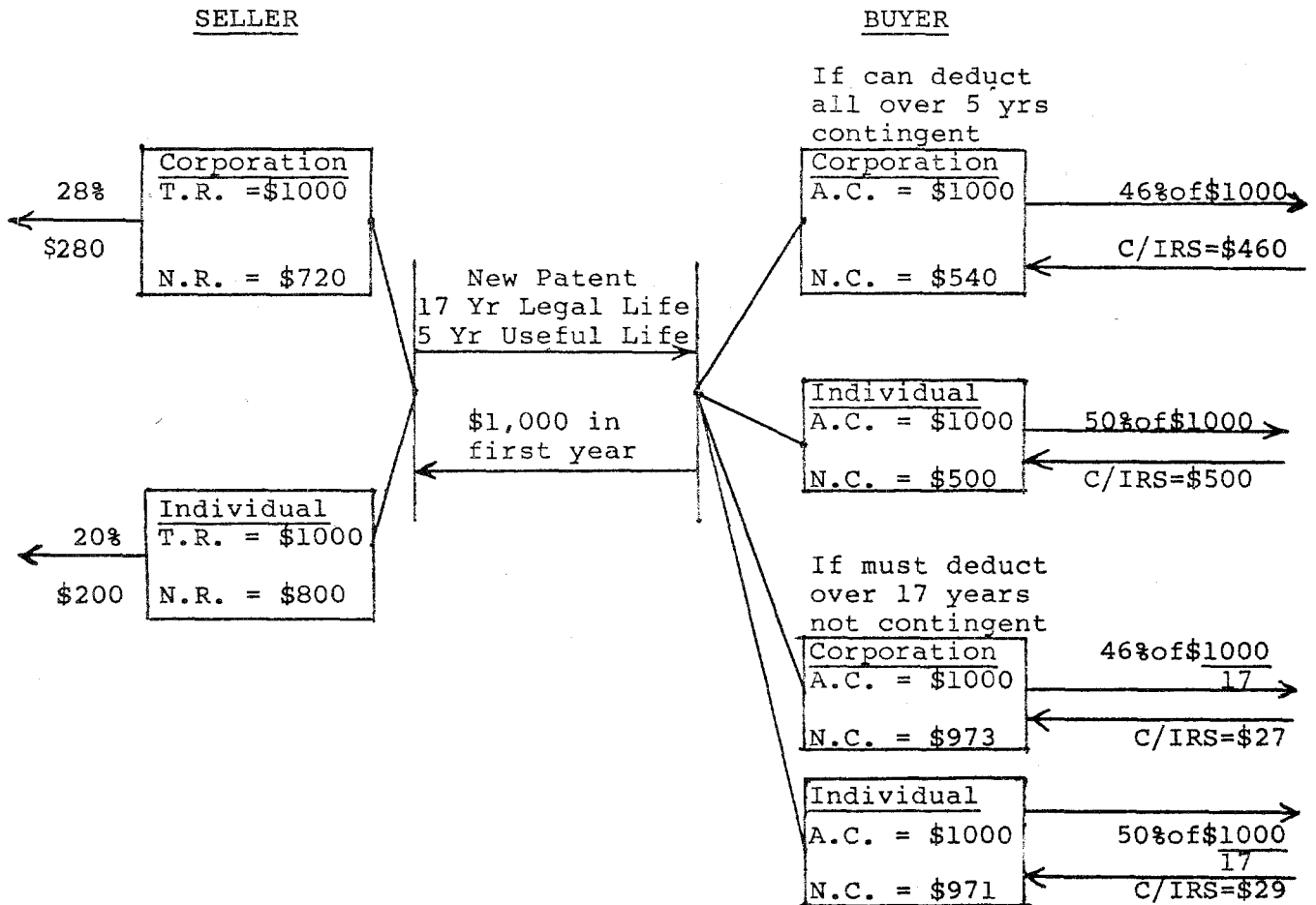
Referring to the right hand side, the buyer side, a corporation will deduct its \$1,000 as an ordinary

Non Exclusive License
Royalty Payments = \$1,000



Example I

Assignment or Exclusive Patent License
(Sale of All Substantial Rights)
First Year Payments
\$5000, Payable \$1000/yr-5yrs



Example II

business expense at a 46% rate. Accordingly, the contribution of IRS is \$460. The net cost to the corporation is therefore only \$540. Similarly, the individual buyer in the 50% tax bracket has a net cost of \$500.

On the left hand side, the seller side, since the corporation must report these receipts as ordinary income, taxed at 46%, the corporation actually receives only \$540.

And finally, in a similar fashion, the individual seller will have net receipts of only \$500.

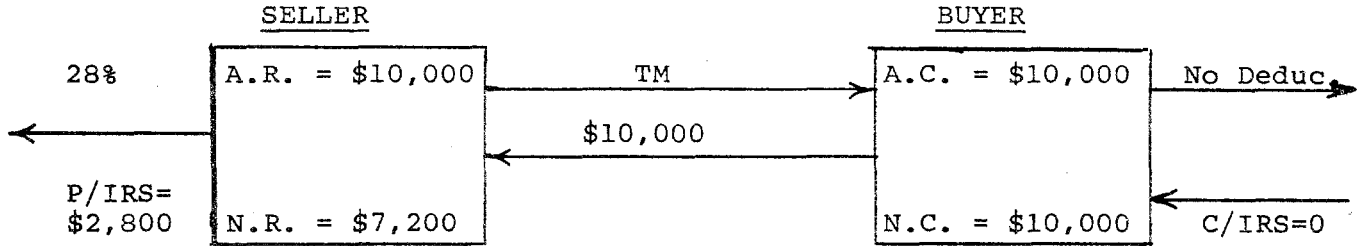
Compare these results to Example No. 2, which concerns an assignment or an exclusive patent license

(that is, a sale of "all substantial rights"). Assume that the total cost is \$5,000, payable \$1,000 per year for five years. This example examines only the first-year payments.

Note the left side of the chart, the seller side. The corporation is paying only 28% and thereby retaining \$720 (instead of the \$540 in Example I) and the individual, taxed at 20%, keeps \$800 (instead of the \$500 in Example I).

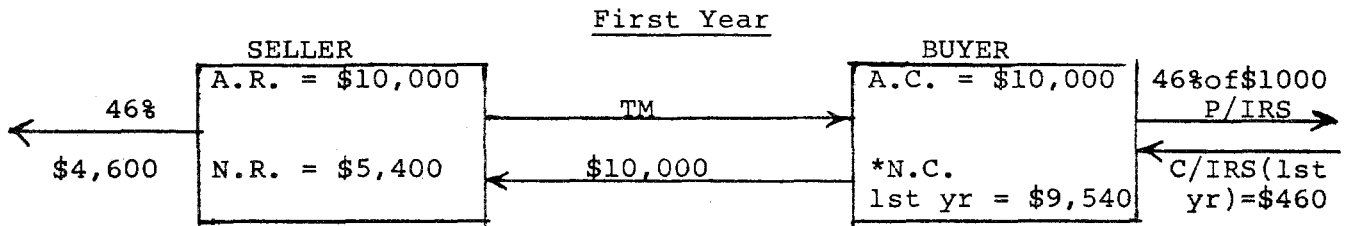
Now note the right side, the "buyer" side. The upper two boxes assume that the buyer can deduct the entire \$1,000 in the first year. Recall that the buyer can

Trademark Transfer
(Corporations Only)
Outright Sale - \$10,000



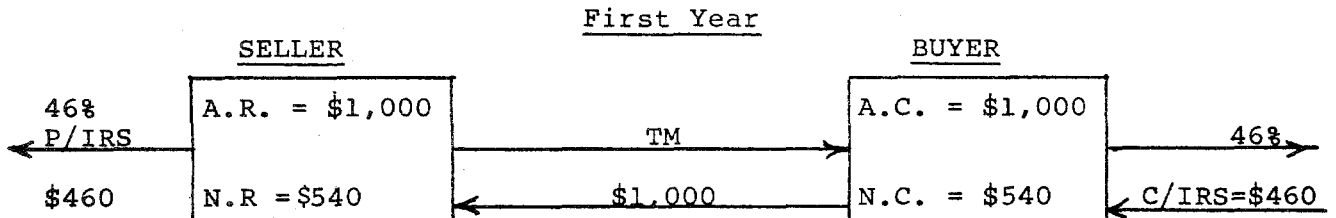
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Seller Retains a Significant Right
Price \$10,000 Lump Sum



*And Can Deduct \$1000/yr for next nine yrs.

Seller Retains a Significant Right
Price \$10,000 payable \$1000/yr for 10 years (either installments or contingent on use of mark)



Example III

deduct all money paid as the depreciation amount in that year when the royalty is contingent on productivity or use of the purchased rights. In this case the deductions substantially reduce the net cost, just as in Example I.

However, now note the lower two boxes on the right side. The assumption here is that the buyer could not benefit by one of the methods for rapid deduction of the purchase costs. In these cases the \$1,000 payment must be prorated over the 17-year life of the patent. Hence, the net cost to the corporation is \$973 and the net cost to the individual would be \$971.

Note the *upper* left boxes in Examples I and II. For the corporation, the gap between the highest ordinary income rate and the long-term capital gain rate is not that large, i.e. it is only 18% (46%-28%). Therefore, two nonexclusive licenses which each provide a net receipt of \$540 would amount to a total net receipt of \$1,080 (compare this with the \$720 received in the exclusive license).

Therefore, when one considers the many commercial benefits of a license that does not transfer all substantial rights, including for example, nonexclusivity, licensing to a related company, field-of-use restriction, geographic restrictions, scope of the claims restric-

tions, etc. the licensor might well find that it is to his benefit to pursue a plurality of such licenses, rather than a single exclusive license that transfers all substantial rights.

Now compare the lower left hand boxes in Examples I and II. In the case of an individual, the gap between the ordinary income rate and the long-term capital gain rate is 30% (50%-20%). This is greater than in the case of a corporation. Nonetheless, individuals might also conclude that for commercial reasons it would often be preferable to enter into a plurality of ordinary income licenses rather than a single exclusive license that transfers all substantial rights.

Example III relates to the transfer of trademark rights. The first trademark example illustrates an outright sale between corporations, while the second and third examples illustrate different license situations between two corporations, where the seller retains a significant power.

In conclusion, the net effect of the payments made to purchase intellectual property take on a different appearance after taxes, and after all, it is primarily the after-tax amounts that are most meaningful to the buyer and the seller.