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PATENTS

Taxing biotechnology

Awareness of the tax issues surrounding biotechnology inventions can help you avoid expensive mistakes.

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You may have written a check to the Internal Revenue Service last month. With the subject of taxes still fresh in your mind, this may be a good time to drive home some points about taxes and biotechnology.

In the first patent granted for a genetically engineered organism, an oil-metabolizing *Pseudomonas,* the US Supreme Court stated that, "Everything manmade under the sun is potentially patentable"[1]. And everything that is potentially patentable is potentially taxable. In addition, there are tax consequences for other forms of intellectual property, such as copyrights for software and trademarked names of companies and their products. Biotechnology executives who want to show shareholders a net income at the end of the year will want to have an awareness of the taxes that might prevent that.

Deduction of development expenses

In the United States, Section 174 of the Internal Revenue Code permits a taxpayer to deduct expenses paid or incurred during the taxable year in connection with a trade or business associated with the biotechnology in question. The words "in connection with," deliberately less stringent, are meant to distance the application of Section 174 from the requirement of having an ongoing business concern, as was previously necessary in order to deduct development expenses. The modern rule is that the taxpayer needs only a "realistic prospect" of going into a business related to the R&D to qualify for the deduction[2].

Capital gains taxes

A short-term capital gain will be taxed as ordinary income, so executives should be on the lookout for opportunities for long-term capital gains treatment. Section 1235 of the Internal Revenue Code allows a patent to have long-term capital gains treatment even to a professional inventor, and regardless of the holding period.

With most properties, the owner is required to hold the property for one year in order to obtain capital gains treatment. With patents, however, an invention made on one day can be sold the next and still receive capital gains treatment. The key to capital gains treatment is to be a "holder," as defined in the Internal Revenue Code. A holder can be the inventor, or one who bought from the inventor, but not those who are merely in privity with the inventor. A holder is defined as one who obtains an interest in the biotechnology before it is actually reduced to practice. Investment partners and investment co-owners who contribute capital can qualify as holders so long as the contribution is made before the invention is fully functional. Constructive reduction to practice does not apply to the Internal Revenue Code definition[3].

The right to deduct R&D expenditures is even more critical to new biotechnology ventures, since the tax advantage of these deductions are not recaptured if the technology is later sold. For example, if a technology developer spends $500,000 for research activities, this amount can be deducted against ordinary income in the year in which the funds were expended. If the technology is later sold by the holder for $1,000,000, all of the sales price will be taxed at the capital gains rate, currently 20%. The first $500,000 of the sales price will not be recaptured because the deduction was for the purposes of encouraging research, and is therefore not related to the later sale of the patent. In contrast, if R&D costs were not deducted, the first $500,000 would have been taxed at the ordinary income rate, and only the remaining $500,000 would be taxed at the lower capital gains rate.

A patent's rights can be divided among parties with a license agreement by geography, type of product, time duration, and the like. However, an agreement for the sale of a patent, rather than a license, must involve the sale of substantially all of the rights in the patent, and only then can capital gains treatment be afforded. Otherwise, the monies received will be treated as ordinary income. In other instances, the taxpayer may have divided the patent rights in a series of nonexclusive licenses. Where the taxpayer is highly involved in administering the licenses and is involved sufficiently to consider it as a business, self-employment tax will have to be paid.

Trade secrets

Trade secrets are like patents but can also be treated, for tax purposes, under general principles of exchange of property. In some cases the sale of property that has potential patentability may come within Section 1235, enabling the owner to realize capital gains on the sale of the property even when held for less than a year.

The ability to treat trade secrets and know-how as patent-like comes from the emphasis on development, and the favorable treatment given to investment that occurs before the trade secrets and know-how are reduced to practice. In the landmark case *Gilson v. Commissioner*[4], a creator of 82 designs was allowed design patent tax treatment even though only two of the designs were patented. *Gilson* is also cited by some for the premise that so long as copyright protection is not sought, the property may be treated as patent-like.

Other similar principles apply to the transfer of know-how and trade secrets. Where a taxpayer develops or collects and sells trade secrets in the course of business, ordinary income will arise under the inventory principle. In other cases, there will be an attempt to determine if there has been a sale or merely a license. As in the case of patents, the IRS requires a transfer of all substantial rights in the trade secret or know-how. However, since a trade secret can have an indefinite life, much like a trademark, the transfer should be without any term limitation. Of course, if the trade secret becomes generally known, it will cease to exist at that time.

Finally, in some cases, by the time a patent matter comes to the IRS's attention, it is too late to take advantage of deductions because the documentation required to prove eligibility and to survive an audit was not acquired in time. Therefore, follow your accountant's advice and keep your receipts, as well as any other important records of financial transactions.

While biotechnology executives cannot be expected to be tax experts, they can be aware of the issues and open the channels of communication between the right departments.

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1. *Diamond v. Chakrabarty,* 447 US 303, 309 (1980).
2. *Scoggins v. Commissioner,* 46 F.3d 950 (9th Cir. 1995).
3. Reg. Sec. 1.1235-2(d)(3).
4. *Gilson v. Commissioner,* 48 Tax Court Memorandum 922(CCH)(US Tax Court 1984).

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