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In this report, the authors analyze tax considerations arising from employer-employee royalty sharing agreements, which are common in the college and university technology transfer setting but can present surprising tax consequences. They describe tax reporting frameworks, choices, and areas of uncertainty for employees and employers.

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The rapid growth of technology transfer from academia to industry has been a signature development of recent decades, and its importance is hard to overestimate. Tech transfer offices are now commonplace at colleges, universities, and academic medical centers across the country, and faculty members and researchers turn out important discoveries daily. Many (if not most) employers, both taxable and tax exempt, require employees who engage in research to assign all rights in any resulting intellectual property to the employer. Often these employers, especially in academia, agree in return to pay the employee an amount determined by reference to any IP royalties received by the employer.[1]

In our experience, the tax consequences of employer-employee royalty sharing agreements (RSAs) are often not fully appreciated.[2] This report seeks to systematically describe and analyze those consequences.

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[1]We are concerned here with patented inventions rather than intellectual properties subject to copyright or other protection, since different types of IP are subject to significantly different tax regimes. *See, e.g.*, section 1221(a)(3) (excluding from the definition of a capital asset copyrights held by creators or a taxpayer whose basis is determined with reference to the creator's basis); *see also* sections 197 and 1253(a) (special rules governing transfers of specific types of IP, such as trademarks or trade names). Also note that some inventions, such as software, may be subject to multiple IP protections. For a thorough exploration of the potential for capital gain treatment of distributions relating to various types of IP likely to be encountered in the university setting, see Edward J. Jennings, "The Taxation and Reporting of Distributions Derived From Licensing Intellectual Property," 15 *Tax'n Exempts* 207 (2004).

[2]"Royalty sharing agreement" is arguably a misleading term, because typically the employee is not receiving a royalty but rather a payment based on the royalties received by the employer. Other terms commonly used for these payments include "royalty distribution," "royalty allocation," "licensing income distribution," "revenue sharing," or simply "inventor payments." We use the term "royalty sharing agreement" because, in our experience, it is the most common.

We examine the potential application of capital gain treatment and installment sale treatment, as well as alternatives. The report also explores reporting and withholding issues,[3] including those raised by RSA payments to nonresident aliens.[4] Although we specifically address the college and university context, much of the discussion applies equally to other kinds of employers, including tax-exempt hospital organizations, research institutes, and for-profit companies.

I. What Is an RSA?

At issue are policies or agreements in which (1) an employee (the inventor) is required to disclose and assign to the employer institution all rights, title, and interest in any invention of the inventor that is conceived or reduced to practice using support, funding, facilities, materials, or other resources provided by the employer; and (2) the institution promises that if it generates revenue from any invention developed by the inventor, it will pay a portion (often about one-third) of that revenue to the inventor.[5] The second prong gives rise to RSAs. The two parts of the agreement might occupy the same document, such as an employment contract or a faculty handbook, or they might be in two separate documents.

Even if clear policies or contractual terms agreed to upon the commencement of employment cover both the rights assignment and the sharing of royalties for the duration of employment, in our experience at least two additional agreements are typically completed for an invention when a patent application is filed. First, an inventor formally acknowledges and memorializes the assignment of patent rights in a document filed as part of the patent application.[6] Second, the employer and the inventor enter into an invention-specific RSA, particularly if payments are to be split among multiple inventors.

II. Capital Gain Treatment for RSA Payments?

A. Capital Gain on Transfers of Patent Rights

Section 1235 treats payments received in exchange for specific transfers of patent rights as long-term capital gain, even if those payments could otherwise be characterized as wages or as royalties constituting ordinary income. Section 1235(a) applies to a transfer[7] of "property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder."[8] Under the section 1235 regulations, the transfer may take place before the patent is granted, or even before the patent application is filed.[9] The term "all substantial rights" means "all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred."[10] Capital gain treatment is available even if, under the terms of the transfer, the payments look like royalties because they are "(1) payable periodically over a period generally coterminous with the transferee's use of the patent, or (2) contingent on the productivity, use, or disposition of the property transferred."[11]

The ability to claim section 1235 treatment for payments made by an employer under an RSA depends on whether the payments are consideration for the inventor's transfer of patent

[3] RSAs raise other types of potentially surprising tax considerations too, relating, for example, to an inventor's donation of RSA rights or payments to the employer university or another donee, an inventor's declining payment under an RSA, and the employer's tax-exempt status.

[4] It is common for employers that recruit talent globally, such as research universities, to have a significant number of nonresident alien inventors. *See, e.g.*, *Washington v. Trump*, 847 F.3d 1151, 1159-1160 (9th Cir. 2017) (discussing the international recruiting efforts of public research universities); *see also* Brief of Technology Companies and Other Business as Amici Curiae in Support of Appellees, *Washington v. Trump*, 847 F.3d 1151 (No. 2:17-00141).

[5] The payment is generally net of patent application and licensing expenses. It is this portion that will be split with other individuals if there are multiple inventors.

[6] We understand that an inventor and an employer university generally file an assignment document for each patent to clarify for patent law purposes that the university is the owner of the patent, even though the inventor may have already assigned all future inventions to the university in an employment agreement or under university policy. *See infra* Section II.C.2 for an exploration of employment agreement or policy language that "assigns" future inventions, versus language that "agrees to assign" future inventions.

[7] The statute excepts transfers by gift, inheritance, or devise.

[8] "Holder" is a defined term under the statute but generally includes the inventor whose work was patented.

[9] Reg. section 1.1235-2(a). The payment is generally net of patent application and licensing expenses, and is split with other individuals if there are multiple inventors.

[10] Reg. section 1.1235-2(b)(i).

[11] Section 1235(a).

rights to the employer, or are instead compensation for services rendered.[12]

B. Was the Inventor 'Hired to Invent'?

If the employer's payments to the inventor are compensation for services rendered as an employee, they are ineligible for capital gain treatment under section 1235.[13] The Tax Court has phrased the inquiry as whether the employee was "hired to invent."[14] If the answer is yes, the logic goes, the inventor was simply doing her job and had no property rights to transfer to the employer in exchange for the payments, and section 1235 would not apply.[15] This determination is made based on all the facts and circumstances of the employment relationship,[16] so employment contracts and policies can go a long way toward making or breaking the employee's case for capital gain treatment.

In 1948 the Tax Court held in *Blum* that an employee was hired to invent because his employment contract specifically required him "to devote his attention to the adaptation of [a] chain saw which the company hoped to manufacture and sell."[17] The court thus found that to the extent the individual's employment related to a chain saw, it was "a contract of specific employment to make an invention." Because the employee had been hired to invent a chain saw, the commissions he received on his employer's sales of the chain saw were held to be compensation for services rendered rather than payment for patent rights transferred.[18] The Tax Court also noted that the employment agreement specifically contemplated that patentable ideas might arise out of the chain saw development and provided that no additional compensation would be paid in exchange for those patents, other than the commission provided for in the employment agreement.[19]

In *Chilton* and *McClain*,[20] both decided in 1963, the Tax Court found that the employees had not been hired to invent, and hence section 1235 applied. Neither case is a model of analytical clarity. In *Chilton*, the Tax Court, finding the employment agreement ambiguous on whether the employee had been hired to apply "inventive ability" or instead to do "engineering work," turned to other evidence to make that determination. Based on witness testimony, the employee's consistent characterization of the payments as received in the business of inventing rather than as compensation (before the then-recent enactment of section 1235), and the employer's consistent characterization of the payments as royalties (rather than as salary) for book and tax purposes, the court found that the payments were made for the transfer of the employee's patent rights.

Similarly, in *McClain*, the Tax Court relied heavily on the fact that the taxpayer was employed by Lockheed Aircraft Corp. generally as an engineer, with no responsibility to apply "inventive ability," so it was clear he was not hired to invent. The taxpayer had signed an employment application in which he agreed to assign any patents or inventions to the employer without further compensation. In fact, the employer made payments to the taxpayer under its separate employee incentive program, which paid employees a percentage of the licensing or sales revenue derived from their inventions, up to a specified cap. The Tax Court held that the employment agreement's silence regarding additional compensation for inventions (as opposed to the employment application, which was not silent) did not defeat the application of section 1235. Interestingly, the court noted (but did not discuss in its analysis) that the employer

[12] For a thorough discussion of other requirements for section 1235 treatment, see Jennings, *supra* note 1.

[13] Reg. section 1235-1(c)(2).

[14] *See Chilton v. Commissioner*, 40 T.C. 552 (1963); and *McClain v. Commissioner*, 40 T.C. 841 (1963).

[15] *Chilton*, 40 T.C. at 562 ("The real question in issue here is whether petitioner was 'hired to invent' aircraft engines and accessories or assigned the duties of devoting himself to such specific inventions. If a person is employed by another 'to invent' a specific product or specific products, the fruits of the employee's labor, the invention, belongs to his employer."); *see also* Jennings, *supra* note 1.

[16] *See, e.g.*, *Beausoleil v. Commissioner*, 66 T.C. 244, 247 (1976).

[17] *Blum v. Commissioner*, 11 T.C. 101, 108 (1948).

[18] Although *Blum* preceded the 1954 enactment of section 1235, the taxpayer sought to treat the commissions as consideration for the sale of a capital asset.

[19] The *Blum* court also noted that the employer and taxpayer had both reported the payments as if they were compensation for many years, until the employee changed his reporting position for the years at issue in the litigation. The court said it did not consider this history in reaching its decision about the nature of the taxpayer's employment.

[20] *Chilton*, 40 T.C. 552; *McClain*, 40 T.C. 841.