Planning for the Tech Entrepreneur

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Who Constitutes a "Tech Entrepreneur"?

Gremlins, 1984

- Client owns IP that he or she believes will be worth $$$ in the future. The IP is not currently part of a functioning business.

Who Constitutes a "Tech Entrepreneur"?

Silicon Valley, 2015

- Client has created a functioning business that utilizes certain items of IP also created by the client. Client believes that the business will be acquired in the future, with such acquisition resulting in a substantial spike in the business's value.

Common Considerations

- This type of client is likely in the asset accumulation phase of his or her life and may be unfamiliar with estate planning, in general, and transfer tax planning, specifically.
- Much like entrepreneurs in other sectors, this type of client will likely require a certain level of liquidity to pursue new assets and ventures.
- Unlike entrepreneurs in other sectors, this type of client may be under increased pressure to sell or otherwise monetize IP assets due to the pace of the tech market.
- **Note that the average age of an entrepreneur in the tech sector is not that different from the average age of entrepreneurs in other fields (e.g., the average age of a software startup founder is 40, compared to an overall entrepreneur average age of 42).**

Types of IP Assets

- Patent: A patent is a contract between the federal government and an inventor under which the government grants the inventor the right to exclude others from making, using, selling, offering for sale or importing an invention in or into the U.S. during the term of the patent. 35 U.S.C. § 101.

  - A "utility patent" protects a new and useful method, process, machine, device, manufactured item or chemical compound or an improvement to any such invention. A utility patent lasts for 20 years from the earliest effective filing date.

  - A "design patent" protects any new, original and ornamental design of a manufactured item. A design patent lasts for 15 years from its issue date.

  - A patent is treated as personal property and is assignable by an instrument in writing. The assignment may be perfected by recording the transfer with the U.S. Patent and Trademark Office by the earlier of 3 months after the assignment's date or prior to a subsequent purchase or mortgage.

Types of IP Assets

- Copyright: A copyright refers to the exclusive legal right to make, distribute, adapt, display or perform an original work of authorship that has been fixed to a tangible medium of expression. 17 U.S.C. § 102.
  - A copyright vests upon creation of the work, although an author may register a copyright with the U.S. Copyright Office to strengthen his or her rights and as a prerequisite to legal action for copyright infringement.
  - A copyright lasts for the author's lifetime plus 70 years.
  - The author of an original work will be the copyright's sole owner with the exception of "work made for hire" and "joint work".
  - A transfer of a copyright ownership must be reflected in "an instrument of conveyance, or a note or memorandum of transfer" to be effective. A transfer may be perfected by recording it with the U.S. Copyright Office.

Types of IP Assets

- Copyright (cont.)
  - With the exception of works made for hire, the exclusive or nonexclusive grant of a transfer or license of a copyright or any right under a copyright executed on or after January 1, 1978, other than by Will, may be terminated by the grantor after 35 years, subject to certain exceptions for the transfer of a right to publish a copyright.
    - If the grantor dies during the 35-year period, his or her termination right will pass to his or her surviving spouse and/or descendants, or, in the absence of both a surviving spouse and any descendants, to the personal representative of his or her estate.
    - The right of termination may be exercised at any time during the 5 years following the end of the 35-year period.
    - A terminating party must provide a signed, written notice of the termination's effective date to the grantee not less than 2 or more than 10 years before such effective date and file a copy of this notice with the U.S. Copyright Office prior to the termination's effective date.
    - The grantor's termination right cannot be waived.

Types of IP Assets

- Trademark: A trademark is a symbol used in commerce to identify and distinguish the source of goods and services. 15 U.S.C. § 1127.

  - Common law trademark protection is granted to the first party to use a trademark and is limited to the geographic area in which the trademark is used.

  - A trademark may be registered with the U.S. Patent and Trademark Office for a 10-year period of protection under federal law and additional 10-year renewal periods.

  - A trademark may only be assigned to another party in writing with the goodwill of the business in which the mark is used and any assignment should be filed with the U.S. Patent and Trademark Office.

Types of IP Assets

- Trade Secret: A trade secret is a piece of information that derives economic value from not being generally known or readily ascertainable by those that could gain value from its use and that is subject to certain measures to maintain its confidentiality. 18 U.S.C. § 1839(3).

  - To transfer the value of a trade secret, the owner must expressly authorize use of the trade secret by the recipient and both parties must ensure the information's continued confidentiality.

  - Trade secrets can receive indefinite protection if the trade secret continues to have economic value, remains secret and reasonable security measures continue to be taken.

Choice of Entity Considerations

- LLC
  - Subject to fewer regulations
  - Pass-through tax treatment
    - No separate tax at the entity level
    - Taxpayer may take unreimbursed business expenses and certain tax credits on his or her personal income tax return

- Corporation
  - Built-in distinction between management and ownership which makes granting equity-only interests easier
  - Capable of issuing incentive stock options to employees
  - Statutory basis and established case law provide comfort to potential investors and purchasers with less due diligence

Valuation Methods: IP

- Cost Approach
  - Reproduction method
  - Replacement method
- Market Approach
  - Sales transaction method
  - Relief from royalty method
- Income Approach
  - Discounted cash flow method
  - Comparative income differential method
  - Monte Carlo method
  - Real options method

Valuation Methods: Entity Interest

- Cost or Asset-Based Approach
  - Does not include goodwill
  - A market or risk adjusted income approach will likely produce a more accurate value
- Income Approach
  - Relies on capitalizing historical earnings or discounting future earnings or cash flow
  - May not always provide an accurate picture as startups tend to incur large costs in the earlier development period and grow rapidly after product commercialization
- Market Approach
  - Guideline public company method
    - Derives valuation multiples from the traded prices of public companies comparable to the subject company
  - Guideline company transaction method
    - Derives valuation multiples from the acquisition prices of public and private companies comparable to the subject company

Securities Law Considerations

- <u>Every</u> offer and sale of a security must either be registered with the Securities and Exchange Commission or subject to an exemption from registration under the Securities Act. The Securities Act defines a "security" very broadly.

- Private Placement Exemption:

  - The specifics of this exemption are not defined under the Securities Act; rather, the Securities Act simply provides that its restrictions do not apply to "transactions by an issuer not involved in a public offering".

  - The U.S. Supreme Court has previously recognized that this exemption applies to situations in which the potential purchasers could "fend for themselves" due to the types of information available to the purchasers and their level of financial sophistication. *SEC v. Ralston Purina Co., 346 U.S. 119 (1953).*

Securities Law Considerations

- Rules 504 and 506 of Regulation D provide safe-harbors under the private placement exemption.

    - Rule 504 permits a business to raise up to $5 million in any 12-month period in private offerings, provided that the use of general solicitation or advertising to market the securities is disallowed unless the offering is registered in a state requiring the use of a substantive disclosure document or sold under a state exemption for sales to accredited investors.

    - Rule 506(b) permits a business to raise unlimited funds in private offerings if certain requirements are met, including a ban on the use of general solicitation or advertising to market the securities, the sale of the securities to an unlimited number of accredited investors and related purchasers and no more than 35 other purchasers who are "financially sophisticated", making certain information available to investors (including all information that would typically appear on a registration statement if non-accredited investors are involved), and ensuring that knowledgeable persons are available to answer questions of prospective purchasers.

Securities Law Considerations

- Rules 504 and 506 of Regulation D (cont.)
  - Rule 506(c) permits a business to raise unlimited funds in private offerings involving the use of general solicitation or advertising to market the securities if all of the investors qualify as accredited investors and the business takes reasonable steps to confirm such status.
  - With the exception of certain securities meeting state registration requirements under Rule 504, the securities purchased under Rule 504 or 506 will be restricted securities and may not be resold for at least 6 months or a year without registering them.

Securities Law Considerations

- An “accredited investor” includes:
  - Any individual that earned income in excess of $200,000 (or $300,000 with a spouse) in each of the prior 2 years and reasonably expects the same for the current year, or has a net worth of over $1 million (either alone or with a spouse), excluding the value of the investor’s primary residence;
  - Certain entities that are required to have assets in excess of $5 million or have equity owners that are all accredited investors; and
  - Any trust with total assets in excess of $5 million, not formed to specifically purchase the subject securities and whose purchase is directed by a sophisticated person.
  - A revocable trust may be an accredited investor if its grantor is an accredited investor.

Income Tax Issues for IP Assets

- Tax Treatment of Different Types of Licenses

  - Under an “exclusive license”, the licensor grants the licensee the use of substantially all of the licensor’s rights in the subject property. Such transfer is treated as a sale for income tax purposes and the licensor is entitled to recover basis in the subject property.

  - Under a “non-exclusive license”, the licensor grants the licensee less than substantially all of the licensor’s rights. Such transfer is treated as a license that generates royalty income for income tax purposes and the licensor cannot recover basis in the subject property. Royalty income is taxed at ordinary income tax rates.

Income Tax Issues for IP Assets

- Capital Asset Treatment

  - IRC § 1221(a)(1) excludes from the definition of a capital asset stock-in-trade, inventory and property held by a taxpayer primarily for sale to customers in the ordinary course of a trade or business.

  - IRC § 1221(a)(2) excludes from the definition of a capital asset depreciable property used in a taxpayer’s trade or business.

  - IRC § 1221(a)(3) excludes from the definition of a capital asset various forms of IP, including a patent, invention, model or design, a secret formula or process and a copyright, if held by the creator of such property or a taxpayer in whose hands the basis of such property is determined in whole or in part with reference to the creator’s basis.

Income Tax Issues for IP Assets

- Capital Asset Treatment (cont.)
  - IRC § 1235 provides that a transfer (other than by gift, inheritance or devise) of property consisting of all substantial rights to a patent (or an undivided interest in all such rights) by a holder will be treated as the sale or exchange of a capital asset held for more than 1 year, regardless of whether payments in consideration for such transfer are made over the transferee's period of use or are contingent upon the productivity, use or disposition of the property.
    - This treatment is not available for a transfer, directly or indirectly, between persons specified in IRC § 276(b) or 707(b), subject to certain exceptions.
    - A "holder" is defined as an individual who either (i) created the patent or (ii) acquired the patent for money or money's worth prior to the covered invention's reduction to practice and who is neither the creator's employer nor a person related to the creator at the time the rights are acquired.
  - IRC § 1253 imposes ordinary income tax rates on payments for the sale of a trademark that are (i) contingent on the productivity, use or disposition of the trademark or (ii) non-contingent if the transferor retains any significant power, right or continuing interest in the mark.

Income Tax Issues for IP Assets

- Donation to Charity
  - IRC § 170(e)(1)(B)(iii) provides that the charitable deduction generated by the contribution of IP is limited to the lesser of the property's fair market value or the donor's adjusted basis.
  - IRC § 170(m) permits the donor of IP to a charity (other than a private non-operating foundation) to recognize an additional charitable deduction in each of the 10 years following the original donation, subject to a sliding percentage scale.
    - This provision only applies to "qualified intellectual property" and the donor must provide notice to the donee organization at the time of the contribution.
    - The donee organization must file a Form 8899 30 days after the end of each the donee's tax years in which the donee receives or accrues net income from the property.
    - The donor's additional deduction is calculated by multiplying the donee's net income from the qualified intellectual property by that year's applicable percentage, provided that such deduction is allowed only after the aggregate amount of net income from the property, as adjusted by the annual percentage limitations, exceeds the amount of any deduction allowed at the initial contribution.

Income Tax Issues for Entity Interests

- IRC § 1202 Qualified Small Business Stock Gain Exclusion
  - IRC § 1202 provides that a portion or all of the gain from the sale or exchange of "qualified small business stock" that has been held for more than 5 years will be excluded from a taxpayer's gross income. Any gain not excluded will be subject to a 28% maximum capital gain rate, plus the 3.8% Medicare surtax.
  - The percentage of gain that is excluded is determined based on the year the QSBS was acquired, with 100% exclusion for QSBS acquired after 9/27/2010.
  - The gain to which the exclusion is applied is capped at the greater of (i) $10 million reduced by the aggregate amount of eligible gain taken into account by the taxpayer for prior taxable years and attributable to dispositions of stock issued by such corporation (i.e., a cumulative limitation) or (ii) 10 times the aggregate adjusted bases of QSBS issued by such corporation and disposed of by the taxpayer in that same tax year (i.e., an annual limitation).

Income Tax Issues for Entity Interests

- IRC § 1202 Qualified Small Business Stock Gain Exclusion (cont.)
  - To qualify for QSBS treatment:
    - The stock must be stock of a C corporation at the date of issuance and must be issued after 8/10/1993. Additionally, the issuing corporation must have been a C corporation and meet certain active business requirements for substantially all of the taxpayer's holding period.
    - The corporation must have aggregate gross assets of no more than $50 million (i) at all times after 8/10/1993 and through the date of issuance and (ii) immediately after the stock issuance.
    - The subject stock must be acquired by a taxpayer at "original issuance" (i.e., either from the issuing corporation in exchange for money or other property or as compensation). Stock acquired at death, through a gift or as a distribution from a partnership will be treated as having been received by the transferee in the same manner as the transferor.
  - IRC § 1045 allows a taxpayer to avoid recognition of gain on the sale of QSBS if such sale proceeds are reinvested into a new QSBS within 60 days from the date of sale, subject to certain restrictions.

Income Tax Issues for Entity Interests

- Donation to Charity
  - Generally, IRC § 170(e) provides that the contributor of an entity interest can recognize an income tax deduction for such contribution (subject to any applicable percentage limitations) equal to the interest's fair market value, reduced by the value of any gain that would *not* be recognized as long-term capital gain if the interest were then sold at its fair market value.
  - IRC § 751 provides that, in the event of a sale of a partnership interest, any proceeds received in exchange for any portion of the partnership interest attributable to the partnership's unrealized receivables or inventory assets would be considered an amount realized in exchange for a non-capital asset.
  - In the event of a "bargain sale" under IRC § 1011, the taxpayer's basis for determining the appropriate charitable deduction will be allocated between the sale and gift portions of the transaction in the same percentage as the amount realized bears to the property's fair market value.

Income Tax Issues for Entity Interests

- Donation to Charity (cont.)
  - IRC § 512(e) provides that stock in an S corporation held by a charity will be treated as an interest in an unrelated trade or business and all items of income and gain allocable to the charity will constitute unrelated business taxable income.
  - IRC § 4943 imposes a tax on a foundation or fund if such entity and its disqualified persons (e.g., substantial contributors, directors, officers and their family members, etc.) own, in the aggregate, more than 20% of an active trade or business.
    - The tax imposed equals 10% of the value of any interest in an active trade or business owned by the foundation or fund in excess of this 20% cutoff, with a potential to increase to 200% of such value if the foundation or fund does not reduce its holdings to permissible levels.
    - However, there are numerous exceptions to this “excess business holdings rule”.

Non-Charitable Transfer Tax Strategies for IP Assets

- Patents – Great Candidates for Lifetime Transfer

  - Basic strategies that remove appreciation from the owner's estate while providing liquidity for future ventures:
    - Sale to an intentionally defective grantor trust
    - Grantor retained annuity trust

  - Income tax considerations:
    - Likelihood of basis step-up at death is small (depending on owner's age) and a power of substitution can be included in the trust agreement to permit a swap of the asset in the event of the owner's impending death.
    - Use of grantor trust structure avoids recognition of gain on sale to irrevocable trust and later promissory note repayment and *should* support IRC § 1235 capital asset treatment.
    - Power of substitution can provide additional method of securing IRC § 1235 capital asset treatment.

Non-Charitable Transfer Tax Strategies for IP Assets

- Copyrights – Poor Candidates for Lifetime Transfer

  - Right of termination during owner's lifetime will likely cause estate inclusion under IRC §§ 2036 and 2037. Thus, only bona fide sale for adequate and full consideration will remove appreciation from the owner's taxable estate and a planner should consider the difficultly in determining the copyright's fair market value, especially in light of potential termination rights.

  - But consider …

    - Selling a portion of the copyright's royalties to an irrevocable grantor trust under a private derivative contract. Trust purchases right to receive, at a stated future date or dates, an amount tied to the value of the copyright or even the performance of the specific tech sector in which the copyright is used.

    - Pledging a copyright with an established royalty stream as security for a loan that can be used to fund trusts for transfer tax purposes. At death, such loan would serve to reduce the value of the author's taxable estate without forgoing a step-up in basis.

Non-Charitable Transfer Tax Strategies for IP Assets

- Copyrights (cont.)
  - Income tax considerations:
    - As a copyright will necessarily survive its creator, a step-up in basis at the creator's death can be incorporated into planning. This benefit must be balanced against that provided by the sale of the asset to remove appreciation from the creator's taxable estate.
    - A copyright could be used to fund a non-grantor incomplete gift trust in a low or no-income tax state to lower the ordinary income tax liability generated by royalties.

Non-Charitable Transfer Tax Strategies for IP Assets

- Trademarks – Limited Options for Independent Transfer

  - A trademark that has substantial value is likely held by (or at least used by) an operating business. As such, any sale of the trademark will be contingent upon its continued use and will trigger an ordinary income tax liability on any built-in gain. A transfer by gift, however, may still be an option.

  - Keep in mind that a failure by the owner to use a trademark in the ordinary course of trade for 3 consecutive years is prima facie evidence of abandonment. Unless the trademark's owner is capable of rebutting such abandonment, the trademark will lose its protection under federal law. Where a registered mark is used legitimately by a related company, such use will inure to the owner. A related company is defined as any person whose use of a mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used.

Non-Charitable Transfer Tax Strategies for Entity Interests

- Basic strategies that remove appreciation from the owner's estate while providing liquidity for future ventures:

  - Sale to an intentionally defective grantor trust
  - Grantor retained annuity trust
  - Spousal lifetime access trust

- Be sure to protect potential QSBS gain exclusion by transferring the interest to trust as a gift, rather than a sale.

Charitable Transfer Tax Strategies for IP Assets

- Consider Charitable Remainder Trusts
  - Tax-exempt entity provides vehicle to convert an article of IP with significant built-in gain into liquid funds for transfer to a non-charitable beneficiary and charity without recognizing gain.
  - Trust may be structured to pay out the lesser of a unitrust amount or the trust's annual net income with an optional makeup provision for years in which the trust's net income exceeds the unitrust amount (a "NIMCRUT"). Such structure is especially well-suited for an asset that is not currently generating income but is expected to do so in the future.
  - The recipient charity must have sufficient means and know-how to either license or sell the IP asset. The charity's receipt of royalty income, less all directly connected deductions, is exempt from treatment as UBTI, except to the extent that the asset is debt financed.

Charitable Transfer Tax Strategies for Entity Interests

- Consider Charitable Lead Trusts

  - A client can effectively "bunch" several years' worth of income tax deductions into one year to offset gain in a year in which the client experiences a liquidity event.

  - The trust can be structured to produce a charitable deduction that equals the amount transferred to the trust's non-charitable beneficiaries and/or the donor's remaining generation-skipping transfer tax exemption.

  - Payment to the charity will be deductible up to the individual deductibility ceilings under IRC § 512(b)(11) if the payee charity is a domestic charity.

Additional Considerations

- Protection Costs
  - What about intellectual property insurance?
- Effect on Potential Sale
  - Consider use of tag-along/drag-along provisions in corporate documents