Beware of potential tax issues when selling self-created intangibles

Many modern businesses rely on intangible assets, such as goodwill, trademarks and customer lists. But the IRS doesn't treat all intangibles the same way. Questions about how these assets are taxed often arise when a business is sold, ownership changes hands, or intellectual property is licensed or transferred.

Generally, intangibles qualify as *capital* assets that generate capital gains or losses when sold. This treatment is beneficial because federal long-term capital gains tax rates (typically 15% or 20%) are lower than ordinary income tax rates (which can be as high as 37%). However, certain "self-created" intangibles *don't* qualify for this favorable treatment. Here's an overview of this issue.

Close-up on self-created intangibles

Under current federal income tax rules, "self-created" means created by the personal efforts of the taxpayer. Specifically, an intangible asset is considered to be created, in whole or in part, by the personal efforts of the taxpayer if:

- The taxpayer's efforts affirmatively contributed to the creation of the asset, or
- The taxpayer directed and guided others in performing the work that created the asset.

That's easy to understand when the taxpayer is a human. It can also extend to corporations, partnerships and limited liability companies (LLCs) that receive contributions of intangible assets from the individuals who created them.

Whether a self-created intangible is treated as a capital or noncapital asset depends on the specific type of intangible.

Self-created noncapital intangibles

When you sell a self-created intangible that's treated as a *noncapital* asset for federal income tax purposes, the transaction produces ordinary income or loss rather than capital gain or loss. This unfavorable treatment may apply if, through your personal efforts, you create and personally hold the following types of intangibles:

- Patents,
- Inventions, models or designs (patented or not),
- Proprietary formulas or processes,
- Copyrights, and
- Literary, musical or artistic compositions.

This treatment also applies to letters, memorandums or similar property prepared or produced for you, even though you didn't actually "create" them.

Substituted basis principle

What happens when the self-created noncapital intangibles listed above are contributed to another taxable entity? The same unfavorable treatment applies if the new owner's tax basis in the noncapital intangible is determined, in whole or in part, by reference to the basis of the person who created it (or who had letters or memorandums prepared or produced). This is referred to as "substituted basis."

For instance, when an affected self-created intangible asset is contributed by the creator to a partnership in a tax-free transaction, the partnership takes over the creator's tax basis in the asset under the substituted basis principle. In this situation, the asset is treated as a *noncapital* asset owned by the partnership. The same treatment applies to tax-free contributions of noncapital intangibles to LLCs that are treated as partnerships and corporations. Subsequent sales of affected assets will result in ordinary income or losses rather than capital gains or losses.

Self-created capital intangibles

The following types of self-created intangibles are treated as favorably taxed *capital* assets:

- Goodwill or going concern value,
- Workforce in place,
- Business books and records,
- Business operating systems,
- Customer-based intangibles, such as client or customer lists and lists of prospective clients or customers, and
- Supplier-based intangibles, such as favorable supplier contracts.

Sales of these assets will result in capital gains or losses, not ordinary income or loss. Often, these intangibles are sold with other business assets, so it's important to properly allocate the total purchase price among the assets acquired — including both capital and noncapital intangibles — based on their fair market values. These allocations should be well supported and documented because buyers and sellers may have differing tax objectives. The IRS may also scrutinize allocations involving intangible assets.

Non-self-created intangibles

How an intangible asset is developed and held affects whether it's considered a self-created intangible and the tax treatment when it's sold. IRS Revenue Ruling 55-706 addressed a situation involving a corporate taxpayer that held intangible assets created by several of its employees. According to the guidance, the C corporation's intangibles were *not* considered to have been created by the taxpayer's personal efforts.

Therefore, the intangibles were *capital* assets owned by the *business*. The rules regarding varying tax treatment based on the specific type of intangible that apply to self-created intangibles didn't come into play. Presumably, the result would be the same for intangibles created and owned by a partnership, an LLC treated as a partnership for tax purposes or an S corporation.

Tread carefully

The tax rules for self-created intangible assets are complicated. You can't do much to avoid the unfavorable federal income tax treatment of self-created noncapital intangibles. But many self-created intangibles are treated as favorably taxed capital assets. If you're planning to sell or transfer intangible assets, we can help you understand how the rules apply to your situation and identify the potential tax implications before a deal is finalized. Contact us to learn more.