



---

## The Taxation of IP in a Nutshell

---

The tax aspects of holding, selling and licensing intellectual property may appear at first instance to be a confusion of rules further obscured by the jargon of accountants. Fortunately, the rules are few and the jargon easily explained. What follows is a brief summary of the taxation of patents, copyrights and trade-marks for the non-tax practitioner.

### Capital Property, Inventory and Eligible Capital Property

In order to understand the tax treatment of patents, copyrights and trade-marks, one must first understand the distinction between capital property, inventory and eligible capital property. Briefly, a capital property generates income without being sold. Premises, tools and equipment are simple examples. Inventory, on the other hand, must be sold in order to generate income.

Eligible capital properties belong to a third class of assets which, prior to 1972, were tax "nothings". Their cost was not deductible and the proceeds from their disposition were not taxable. Examples include goodwill and, as we shall see, copyrights and trade-marks that are not inventory. Special rules now apply to eligible capital properties as is briefly discussed below.

### The Tax Treatment of Patents, Copyrights and Trade-marks

#### Patents

In most cases, a patent will be held on capital account and depreciated at a rate of 25% per annum on a declining balance basis. However, the taxpayer can elect to deduct the patent's cost over the life of the property on a straight-line basis. If the patent is later sold, the amounts previously deducted as depreciation will be added back into income and be fully taxable. This is known as "recapture". To the extent that the sale proceeds exceed the

original cost amount, such excess will be treated as a capital gain, only one-half of which would be taxable. For example, assume that a patent cost \$10,000.00, that \$5,000.00 was deducted as depreciation and that the patent was then sold for \$15,000.00. The first \$5,000.00 would be tax free, given an undepreciated cost amount of \$5,000.00; the second \$5,000.00 would be fully taxable, given that it had previously been deducted from ordinary income; and, the third \$5,000.00 would be one-half taxable as a capital gain.

#### Copyrights

It is difficult to generalize whether copyrights tend to be held on capital or income account. A taxpayer might well have used a copyright as an income-producing property with no initial intention of selling, in which case the copyright would likely be held on capital account. Courts are apt to find, however, particularly in the case of software developers, that a copyright is held as inventory, even though the copyright is retained by the developer and only licences are given. Careful consideration must be given as to whether a particular copyright is held on income or capital account.

If a copyright is held as inventory then its cost would, in effect, be fully deductible in the year of acquisition and the proceeds from its sale would be fully taxable. If a copyright is held on capital account then, unlike a patent, it would be an "eligible capital property" and its cost amount would be an "eligible capital expenditure". Three-quarters of eligible capital expenditures are pooled and depreciated at a rate of 7% per annum. The remaining one-quarter would be neither deductible nor subsequently taxable on a disposition. It would remain a tax "nothing". When the copyright is later sold, one-half of the sale proceeds would be deducted from the balance of the pool and, to the extent that a negative balance is obtained, would be included



in income. Therefore, if a copyright cost \$10,000.00, only 7% of \$7,500.00 could be deducted each year on a declining basis. If the copyright is sold after an aggregate of \$3,000.00 had been deducted, \$5,000.00 (one-half of \$10,000.00) would be deducted from the pool of \$4,500.00 (\$7,500.00 minus \$3,000.00) resulting in an income inclusion for the vendor of \$500.00. The tax treatment of copyrights upon disposition is more favourable than for patents since eligible capital expenditures previously deducted are only one-half taxable instead of fully taxable as recapture.

#### *Trade-marks*

In most cases, a trade-mark will be held on capital account. This simply recognizes that most trade-marks are created by the taxpayer in the course of developing goodwill rather than bought and sold as inventory. Like copyrights, however, trade-marks are not capital assets per se but are instead eligible capital properties. The above comments in relation to copyrights held on capital account apply equally to trade-marks.

#### **Licensing versus Sale**

The foregoing discussion assumes that the intellectual property is to be sold. Frequently, however, intellectual property is licensed instead. Licence fees, or royalties, are fully taxable as income. The one benefit they offer from a tax perspective, however, is that royalties are taxable in the year in which they are earned. In this connection, it should be noted that reserves are only available for

proceeds from the disposition of capital property, not eligible capital property. Consequently, proceeds from the disposition of copyrights and trade-marks (but not patents) are taxable in the year of the sale notwithstanding that they are not receivable until future years. Instead of selling a trade-mark or a copyright for \$15,000.00 and being taxable in the current year on \$7,500.00, one could earn annual royalties of, say, \$3,000.00 per annum for five years. Unfortunately, the cost of recharacterizing a sale as a licence is to convert gains which are only one-half taxable into fully taxable royalties.

#### **About the Author**

#### **Patrick Westaway, B.A. (Hons), LL.B.**

Patrick Westaway is Tax Counsel to Sorbara, Schumacher, McCann LLP, one of the largest and most respected regional law firms in Ontario. Patrick advises on a broad range of Canadian taxation issues such as corporate tax planning, structuring inbound investments, corporate reorganizations, cross-border financings, tax opinions for public disclosure documents, tax assessments, personal tax matters, wealth preservation, and on federal and provincial sales tax matters (HST/GST/PST). Patrick also practices corporate and commercial law with an emphasis on the implementation of matters related to his tax planning practice.

#### **Practice Groups:**

Corporate Tax Planning, Corporate and Commercial

This article is intended only to inform and educate. It is **not legal advice**. Be sure to contact a lawyer to obtain legal advice on any specific matter.