Wiggin & Dana

Estate Planning Advisory

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A periodic publication of our Trusts & Estates Department, the Wiggin & Dana Estate Planning Advisory is intended to inform clients and other interested persons about issues and developments in the law affecting trust and estate administration and estate and tax planning for individuals and their families, fiduciaries, investment advisors and business owners. This issue of the Estate Planning Advisory focuses on planning issues relating to intellectual property.

Estate Planning Issues Relating to Intellectual Property

Authors, artists, inventors and others involved in creative activities often own unique assets that can present challenging tax and estate planning issues. Published and unpublished literary or musical works, visual art, computer programs, mechanical inventions, and clothing, jewelry and architectural designs can all be valuable (but difficult-to-value) assets. Such assets, usually known as "intellectual property," are often protected by copyright or patent law. In addition to protecting the commercial interests that such assets can generate, copyright and patent laws can regulate how these assets are transferred during life and at death. This can be particularly important in situations where family members and other survivors do not have reliable records of sales or gifts made by an artist, author or inventor over the years. Also, the rights of a creator of intellectual property are sometimes different than the rights of a transferee (whether by gift or sale). Untangling the respective rights and interests of heirs, business associates and others can be a complex undertaking.

If you or a family member has been involved in creative work, you will want to have at least a general understanding of some of the income and estate tax planning issues that can arise when such property is transferred or when the owner of such property dies. This Estate Planning Advisory is intended to help you think about the key issues. However, just as each item of intellectual property is unique, so are each person's family and financial circumstances. This Advisory can only provide a general overview of some of the issues, and cannot address all of the factors that may come into play in a specific situation. Depending on the facts, an individualized analysis of your particular situation may be warranted.

What is Intellectual Property?

Intellectual property consists of creations of the human mind or, more specifically, *expressions of ideas and knowledge*. In general, intellectual property laws protect intellectual property from the unauthorized use of such property by others. Two main categories of intellectual property are **Copyright**, which covers literary, musical and visual works, such as novels, textbooks, poems, plays, music scores and recordings, films, drawings, paintings, photographs, sculptures and architectural designs; and **Patents**, which cover inventions in their functional aspects, such as mechanical and biochemical processes, and their non-functional, or design, aspects.

Copyright. Copyright is a form of protection granted by law for original works of "authorship" (whether literary, musical or visual) that are "fixed in a tangible medium of expression," *e.g.,* written down or recorded on audio or video tape. Copyright does not protect facts or ideas; it protects the way ideas or facts are expressed. Thus, an artist's initial concept for a given project cannot be protect-

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The Wiggin & Dana Estate Planning Advisory is a periodic newsletter designed to inform clients and other interested persons about issues and developments in the law affecting trust and estate administration and estate and tax planning for individuals and their families, fiduciaries, investment advisors and business owners. Nothing in the Estate Planning Advisory constitutes legal advice, which can only be obtained as a result of personal consultation with an attorney. The information published here is believed to be accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues. If you would like to be added to the distribution list for the Wiggin & Dana Estate Planning Advisory, please contact Gail DeNardis at 203.498.4427.

ed by copyright, but after the artist develops the concept into a tangible work of art, copyright protection attaches. Notably, a work has copyright protection from the moment it is created; there is no requirement that the work be published or registered with the United States Copyright Office. Nonetheless, registration is generally advisable to better protect one's legal rights.

Under copyright law, the creator of the original expression in a work is usually its "author." Special rules apply, however, to a "work for hire," which is a work prepared by an employee within the scope of employment or a work commissioned for a specific purpose (identified by statute) that the parties agree, in writing, is a work for hire. With respect to works for hire, the employer or commissioning party is considered the "author." The author is the owner of the copyright unless there is a written agreement whereby the author assigns the copyright to another person, such as a publisher. Notably, selling a piece of artwork or other tangible expression of an idea does not automatically entail selling the copyright in the work. So artists and other "authors," as well as collectors and other purchasers, need to be clear in their contracts of sale about exactly what is being sold - the tangible item alone or the tangible item, together with the intangible rights relating to it.

The length of protection afforded to copyrighted works varies with the date of creation and the surrounding circumstances. A work created on or after January 1, 1978, for example, is protected from the moment of its creation until 70 years after the author's death. In the case of work prepared by two or more authors, the protection lasts for 70 years after the last surviving author's death. The duration of copyright in a work for hire is 95 years from publication or 120 years from creation, whichever is shorter. The extended period of time afforded copyrights, which can span several generations after the death of the creator, means that families of successful creators of copyrighted works will want to be vigilant in protecting those interests. It also means that accurate valuation of copyrights can be an especially difficult task.

Patents. A patent is a right, granted by federal law to an inventor, to exclude others from using or commercially exploiting an invention in exchange for public disclosure of the invention after the patent is granted. Unlike copyright protection, patent protection is not automatic. The inventor must file an application with the United States Patent and Trademark Office (the "PTO"), which, after a formal examination process, either grants or denies the patent. The most common type of patent is a utility patent, granted to a person who invents or discovers a new and useful process, machine, or article of manufacture. Another type of patent, a design patent, is granted to anyone who invents an original and useful ornamental design for an article of manufacture. Examples of other things that may qualify for patent protection are certain computer software products and internet innovations, and food products (including genetically engineered plants).

Once granted, design patents protect the interests of the patent holder for 14 years from the date of the grant; utility patents extend for 20 years from the date the application was filed. Although the duration of a patent is considerably shorter than that of a copyright, questions of ownership and competing rights can still pose thorny problems, as can valuation issues.

TRANSFERRING PATENTS AND COPYRIGHTS

Like other items of personal property, patents and copyrights can be transferred during life or at death. Lifetime transfers may be by sale or by gift, whereas transfers at death may be by will (a specific bequest or simply as part of the owner's residuary estate), or by operation of law (*e.g.*, if there is no valid will). As with any other substantial asset, owners of intellectual property may want to consider transferring such property as part of a gifting strategy to reduce estate tax exposure. One challenge, however, is that such property is often more difficult to manage and value than other assets.

Assignments and Licenses. Patents and copyrights are frequently described as "bundles of rights" because each has several components that can be transferred in whole or in part. For example, an inventor may assign a patent to two or more joint owners. Alternatively, a patent owner may grant a license in a patent. Under a licensing agreement, the patent owner authorizes another person to exploit the patented invention, but does

If intellectual property makes up a sizable portion of your estate, proper planning of lifetime and testamentary transfers is definitely advisable. Also, if you inherit literary or other creative works, you will want to have a full understanding of the possible value of these assets and what uses are (and are not) permitted. The attorneys in Wiggin & Dana's Trusts & Estates Department are prepared to assist you in all facets of estate planning, including helping you to set up ways to effectively transfer intellectual property assets to family members or others (such as charities). The names and telephone numbers of the attorneys in our Trusts & Estates Department are printed on page four. In addition, Mary Norris, chair of Wiggin & Dana's Intellectual Property Practice Group, can be reached at 203.498.4377.

not actually transfer the patent. Thus, the patent owner may retain the right to also exploit the patent, may retain the right to license the use of the patented invention to others, or may limit the use of the licensed rights to a specific geographic area or for a limited period of time. Similar parsing of rights may occur with respect to copyrights. For example, an artist may sell a painting without relinquishing any of the copyrights to the work, but might license the buyer to put the image to commercial use, such as in postcards that display the image. In such a case, the licensing agreement might provide for royalty payments to the artist based on the number of postcards sold.

The transfer or sale of a patent requires a written instrument (usually an assignment). The transfer or sale of copyrights, on the other hand, does not always require a written instrument. A writing is not required to transfer copyrights on a non-exclusive basis, while transfer of a copyright owner's exclusive rights requires a written instrument signed by the transferor. The potential for informal transfers of copyrights is a further complicating factor for valuation purposes.

Employment Contracts. Employment contracts can significantly affect the ability of a creator to transfer a patent or copyright. In many industries involving creative work, it is not uncommon for employees to be required to sign employment contracts that assign all of the employee's patent rights to inventions made during the period of employment to the employer or that agree that all copyrightable works created during the period of employment will be treated as works for hire. The existence of these contract provisions will interfere with any attempted transfer by the creator and can thwart heirs that might have otherwise inherited valuable assets.

Special Copyright Termination Rights. One unusual feature of copyright law is that an author may be able to terminate prior transfers or licenses of copyrights if certain conditions are met. With certain exceptions, present law permits termination of a grant of rights made after 1977 during a 5 year period beginning 35 years after the grant; other time periods apply for grants made prior to 1978. In other words, if the statutory conditions are met, an author can exercise the right of termination and essentially cancel all previous transfer or licensing agreements, and make new arrangements for the use of the copyrighted works. If the author dies before the termination right vests, this right passes by statute to the surviving spouse and children (or more remote descendants) of the author; if there is no surviving spouse or descendants, the executor of the author's estate (or other fiduciary) can exercise the termination right. This termination right can be of immense value if a creator, or the creator's heirs, think that a copyrighted work is not being marketed properly.

SPECIAL TAX RULES APPLICABLE TO PATENTS AND COPYRIGHTS

Income Taxes. Assets protected by patents or copyrights are subject to special tax rules that should be considered before transfers or licenses of those assets are granted. Notably, the effect of the special tax rules may depend on whether the taxpayer is the original creator or a transferee. For example, the Internal Revenue Code provides that an inventor who sells all of the substantial rights of a patent is entitled to treat payments received on account of the sale as capital gain. This rule applies only to inventors, however, and not to individuals who receive patent rights through a sale or gift from the inventor. In the case of transferees, the "holding period" of a patent determines whether payments received for a subsequent sale of the patent qualify for capital gain treatment. The holding period begins when the invention is "reduced to practice," meaning there has been at least one successful use of the invention. If a transferee takes possession of a patent within 18 months after the holding period begins, any gain on a subsequent sale will be treated as ordinary income. Only if the transfer is after the initial 18 month period will a subsequent sale by the transferee be eligible for capital gains treatment. Different tax rules apply to copyrights. Because copyrights are not treated as capital assets, all gains from their sale must be reported as ordinary income.

Charitable Gifts. In general, charitable deductions are not allowed for gifts of partial interests in property, and this principle applies to donations of various interests in intellectual property. Thus, an income tax charitable deduction is allowed for a gift of intellectual property only if the gift represents the

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donor's entire interest in the property (whether or not that interest is, in fact, all of the property). For example, if a donor contributes a license to use a patent, but retains the right to license the patent to others, the contribution is not deductible because of the retained right. But if a co-author who owns 50% of the copyright in a book contributes that 50% interest, he or she can claim a charitable deduction because the 50% interest represents that author's entire interest in the property. Nonetheless, creators of intellectual property often feel short-changed by the charitable deduction rules because of the value of the deduction that can be claimed. Creators of copyrighted works cannot claim the full fair market value of the property as a deduction, but are limited to an amount equal to their basis in the property (*i.e.*, the cost of creating the property, not including the personal services of the creator). Similar limits usually apply to gifts of patents if the gift is by the original patent-holder or is otherwise classified as a capital asset. These rules have been a source of considerable frustration to creators with charitable instincts but not-unlimited resources and the museums and other educational institutions that would be the most likely recipients of these gifts.

A full discussion of the income and estate tax charitable deduction rules applicable to intellectual property is beyond the scope of this Advisory. Suffice it to say that a thorough analysis of the tax consequences of any such charitable gift should be undertaken before the gift is made.

VALUATION AND OTHER ISSUES.

Appraisers and Special Fiduciaries. Unlike cash and marketable securities, the value of intellectual property can be difficult to quantify. An appraisal of a tangible work of art involves subjective aesthetic judgments, as well as an analysis of price trends as specific artists and types of art fall in and out of favor with collectors and the general public. Likewise, an appraisal of the copyright in the ideas expressed in a work of art must take these matters into consideration. In addition, copyrights and patents exist for fixed periods of time. A valuation of a copyright and patent requires estimating the potential earnings that could be derived from the patent or copyright over that time period. Existing licensing agreements or limited assignments will also affect the value of a patent or copyright. Using an appraiser with special training and expertise in the intellectual property field, who will be attentive to the nuances of patents and copyrights, is usually recommended if substantial value is at stake.

For similar reasons, a creative person might want to consider selecting a knowledgeable individual to serve as a special fiduciary after his or her death. An author of several literary works, for example, may appoint a family member as executor to oversee the general administration of his or her estate, but might also carve out specific duties, pertaining only to the literary works, that are to be performed by a special fiduciary (sometimes called a "literary executor") with experience in the literary field. This may help to ensure that the literary works are managed in the most profitable way possible after the author's death.

Recordkeeping. Maintaining records of all transactions involving your assets is crucial. This is especially true where intellectual property assets are concerned, because of their unique divisible and transferable qualities that distinguish them from other assets. By tracing previous transfers to third parties, thorough records give an appraiser a basis for analyzing any rights retained that might affect value or other aspects of a creator's estate plan. In addition, thorough records will help defend against any copyright or patent violations that occur, whether before or after the creator's death.