

be a bad outcome given our nation's need to increase the domestic savings rate to finance the installation of productivity-improving capital in our businesses, and to lessen our dependence on foreign sources of finance. Again, more broadly and alternatively, there are many small changes in scheduled benefits and system revenues that can be made together, so that Social Security can be put on a financially sustainable base for the long run, without the need for increasing payroll taxes.<sup>3</sup>

An appropriate, specific technical improvement to the current method of calculating the average wage index that would produce a fairer program is to use the earnings (wages and self-employment income) just of workers with earnings below a fixed percentile in the earnings distribution, say 94 percent, reflecting historical norms.<sup>4</sup> More fundamentally, a better approach to guide the structure of Social Security payroll taxes in reform proposals is to eschew arbitrary goals, like the one targeting total taxable earnings to be 90 percent of aggregate earnings. Instead we should tie the type and levels of revenues used to fund the Social Security program with the design and purpose of a universal government program providing modest levels of retirement, survivors, and disability insurance. Fairness is an appropriate consideration here, and suggests both tying the benefit earned to the amount paid in, as well as some redistribution of retirement resources to those with low lifetime earnings. Redistribution itself should also be done fairly, however, unlike the deficit reduction commissions' proposals.

<sup>3</sup>My suggestion summarized in a recent article is one such proposal. "A Pro-Growth and Progressive Social Security Reform Proposal," *Tax Notes*, Jan. 12, 2009, p. 283, *Doc 2008-26247*, or 2009 *TNT* 7-51. (For a full description and score of the proposal, see <http://www.ssa.gov/OACT/solvency>, memo dated Sept. 17, 2008.) It includes raising the normal retirement age gradually, including state and local government workers in the program, reforming the disability insurance program, and so on.

<sup>4</sup>Note also that this fix would have prevented the recent mistake by the SSA in the calculation of the average wage index whereby a few erroneous tax form filings purporting astronomical earning levels were entered into the system and skewed the published average wage index until an external source reported the error, and the SSA did a correction. (For prior coverage, see *Tax Notes*, Nov. 8, 2010, p. 735, *Doc 2010-23596*, or 2010 *TNT* 215-6.)

## The Unequal Tax Treatment of Intellectual Property

By Jeffrey A. Maine and Xuan-Thao Nguyen

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The tax treatment of intellectual property receives surprisingly little attention despite intellectual property's important role in the economy. In this article, Maine and Nguyen evaluate the fairness of the intellectual property tax system, identifying differences in the tax treatment of what appear to be similar transactions. The authors argue that disparate tax treatments between seemingly similar owners indicate potential flaws in the tax system. This article draws on the authors' recent collaboration, "Equity and Efficiency in Intellectual Property Taxation," 76 *Brooklyn L. Rev.* 1 (2010).

### Introduction

The code contains several special provisions governing valuable intellectual property assets, such as patents, copyrights, and trademarks. Some of these special provisions address a large group of intellectual property assets<sup>1</sup>; most, however, address only a specific type of intellectual property.<sup>2</sup> Although these special tax rules were largely designed to address the shortcomings of traditional taxation principles in the intellectual property context,<sup>3</sup> many special tax rules are circumscribed in ways that relegate the tax analysis back to these traditional principles. Thus, the income tax system governing intellectual property is a mix of special tax rules and general tax principles.

Ideally, the intellectual property tax system should embrace the principle of fairness. Tax fairness is usually described in terms of horizontal equity, which requires that persons who are similarly situated be taxed in a similar fashion.<sup>4</sup> A

<sup>1</sup>See, e.g., sections 167(g)(6), 170(e)(1)(B)(iii) and (m), and 197.

<sup>2</sup>See, e.g., sections 41, 167(f)(1), 167(g)(8), 174, 263A(h), 1221(a)(3), 1221(b)(3), 1235, and 1253.

<sup>3</sup>See Xuan Thao Nguyen and Jeffrey A. Maine, "The History of Intellectual Property Taxation: Promoting Innovation and Other IP Goals?" 64 *SMU L. Rev.* \_\_\_\_ (2010) (forthcoming).

<sup>4</sup>See John A. Miller and Maine, *The Fundamentals of Federal Taxation* 4 (2d ed. 2010); Michael J. Graetz and Deborah H. Schenk, *Federal Income Taxation: Principles and Policies* 28 (6th ed.

(Footnote continued on next page.)

## COMMENTARY / VIEWPOINTS

related concept is that economically equivalent activities should be taxed in the same manner even if they differ in form.<sup>5</sup> Under horizontal equity, two patent owners who are similarly situated, or two copyright owners whose situations are similar, should be taxed in a similar fashion.

The utility of horizontal equity in tax policy analysis has come under attack in recent years.<sup>6</sup> Some critics point to the difficulty in determining relevant likeness (that is, the comparison of taxpayers and economic activities).<sup>7</sup> Requiring equal tax treatment for equals, they argue, begs the question of what equals actually are. For example, is the seller of a copyright on a novel equal to a seller of a copyright on a song? This criticism, however, rests on an “exaggerated view of the level of precision required in order for equality to have meaning.”<sup>8</sup> As suggested by one commentator, “horizontal equity is concerned with individuals who are ‘similarly situated,’ not with those who are ‘identically situated.’”<sup>9</sup> Moreover, even if this criticism of horizon-

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2009). For early treatments, see Richard A. Musgrave, *The Theory of Public Finance: A Study in Public Economy* 160 (1959) (“Perhaps the most widely accepted principle of equity in taxation is that people in equal positions should be treated equally”); Henry C. Simons, *Federal Tax Reform* 11 (1950) (“Equity in this primary sense must, in an advanced nation, predominate over, if not wholly override, all other objectives”); see also Joseph T. Sneed, “The Criteria of Federal Income Tax Policy,” 17 *Stan. L. Rev.* 567, 574-580 (1965).

<sup>5</sup>See Jeffrey H. Kahn, “The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity,” 57 *Hastings L.J.* 645, 647 (2006) (using the term “parallelism” for the proposition that “the same or equivalent receipts, expenditures or losses should be treated the same by the tax law”); Eric M. Zolt, “The Uneasy Case for Uniform Taxation,” 16 *Va. Tax Rev.* 39, 49 (1996) (using the term “uniform taxation,” which rests on the concept of horizontal equity, “to refer to tax treatment in accordance with some general approach . . . without any differentiation as to type of income or type of taxpayer”).

<sup>6</sup>See generally Paul R. McDaniel and James R. Repetti, “Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange,” 1 *Fla. Tax Rev.* 607 (1993); see also Anthony C. Infanti, “Tax Equity,” 55 *Buff. L. Rev.* 1191, 1193-1194 (2008); Eric M. Zolt, “The Uneasy Case for Uniform Taxation,” 16 *Va. Tax Rev.* 39, 89-97 (1996) (summarizing criticisms of horizontal equity).

<sup>7</sup>McDaniel and Repetti, *supra* note 6, at 612-613; Zolt, *supra* note 6, at 95 (“Defining horizontal equity as requiring equal tax treatment for individuals who are, in all relevant aspects, equal accomplishes little. It just begs the question of what is relevant. . . . The principle of horizontal equity does nothing to determine which differences justify different tax treatment”).

<sup>8</sup>John A. Miller, “Equal Taxation: A Commentary,” 29 *Hofstra L. Rev.* 529, 545 (2000) (“All of our major tax schemes have found ways to determine likeness (or difference) that are generally recognized as fair”).

<sup>9</sup>David Elkins, “Horizontal Equity as a Principle of Tax Theory,” 24 *Yale L. & Pol’y Rev.* 43, 44 (2006) (“Tautologically, any conceivable tax arrangement will treat identically situated taxpayers equally. . . . Taxpayers are similarly situated when their situations are considered equivalent”).

tal equity is valid, horizontal equity can still serve as a useful tool to uncover potential problems in the intellectual property tax regime.<sup>10</sup> To use the example above, the tax system’s different treatment of literary copyrights and musical copyrights might signal a flaw in the intellectual property tax system, or it might at least challenge us to justify disparate treatment.<sup>11</sup>

This article evaluates the intellectual property tax regime in terms of horizontal equity. In the eight examples that follow, we highlight differences in tax treatment of what appear to be similar intellectual property transactions. We believe that many of these tax distinctions lack theoretical justification, suggesting legislative or administrative changes may be warranted. Ideally, the government should establish a sound basis for making tax distinctions for intangible intellectual property rights if distinctions are to be adopted and maintained.

### Unequal Tax Treatment of IP Development

**Example 1: Patent Development.** Inventor A and Inventor B each spend \$100 to develop a patented invention. Inventor A plans to enter a future business of her own with her developed technology and market the technology herself. Inventor B, however, plans to license her developed technology to a company that will market the developed technology to its customers.

Inventor A and Inventor B appear similarly situated; each spends \$100 and each obtains patent protections for similar technologies that will be exploited in the commercial marketplace. Nevertheless, under the present tax system, Inventor A and Inventor B are not treated equally. Inventor A may deduct \$100 in research costs, but Inventor B may not.

This disparate treatment stems from section 174, which allows a deduction for research expenditures

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<sup>10</sup>See Kahn, *supra* note 5, at 651.

<sup>11</sup>Many commentators have recently defended horizontal equity as an important principle of tax theory despite the criticisms noted above. See, e.g., Samuel A. Donaldson, “The Easy Case Against Tax Simplification,” 22 *Va. Tax Rev.* 645 (2003) (arguing that equity and efficiency, as opposed to simplicity, are core values); Elkins, *supra* note 9 (showing independence of horizontal equity as a principle of tax theory); Brian Galle, “Tax Fairness,” 65 *Wash. & Lee. L. Rev.* 1323, 1328, 1335-1362 (2008) (providing justifications for tax fairness and claiming that horizontal equity “can be defended as an essential feature of the revenue function of taxation” and can operate on principles of its own); Kahn, *supra* note 5 (recognizing that equal treatment of the same items serves the normative goal of fairness, but arguing that parallelism need not necessarily prevail over other legitimate goals); Miller, *supra* note 8 (discussing the merits of horizontal equity analysis).

incurred “in connection with” the inventor’s “trade or business.”<sup>12</sup> While a taxpayer need not be currently conducting a business (that is, producing or selling any product) for research expenditures to meet section 174’s trade or business requirement,<sup>13</sup> courts have required that a taxpayer show a realistic prospect of entering into a trade or business in the future that will exploit the technology under development.<sup>14</sup> To do so, the taxpayer must demonstrate both an objective intent to enter into the trade or business and the ability to perform the business.<sup>15</sup>

In a recent case, the Ninth Circuit affirmed a Tax Court decision that denied deductions to a computer software developer who did not market the developed technology himself, but instead licensed the technology to another company for use in that company’s trade or business.<sup>16</sup> A few Tax Court decisions have held that research activities, and exploitation of the resulting inventions by sale or license, may constitute a trade or business.<sup>17</sup> These

cases, however, involved inventors that had developed several inventions.<sup>18</sup>

The unequal tax treatment of the novice inventors in the example highlights a fundamental problem with section 174; namely it fails to recognize the importance of technology licensing in today’s economy and favors only inventive activities of a sufficiently sustained character.

**Example 2: Copyright Creation.** ABC Inc. spends \$100 to develop copyrighted books. EFG Inc. spends \$100 to develop copyrighted software. XYZ Inc. spends \$100 to create copyrighted package designs used in advertising.

In general, costs incurred in creating works that are subject to copyright protection are not deductible but must be capitalized.<sup>19</sup> Congress has carved out a narrow exception for specified costs incurred by individual writers, photographers, and artists when engaged in their trades.<sup>20</sup> As a result, expenses incurred by an individual author in writing a book are deductible, but similar creative costs incurred by a book publishing company (costs of writing, editing, and designing) must be capitalized.

Although corporate taxpayers must generally capitalize copyright creation costs, capitalization is not required if the subject of copyright protection is computer software<sup>21</sup> or certain advertising materials.<sup>22</sup> As a result, a corporation may not deduct the costs of developing copyrighted books, films, or songs, but it may deduct the costs of developing

<sup>12</sup>Section 174(a). A current deduction is not available under section 162 because of section 263. Section 263(a); reg. section 1.263(a)-4.

<sup>13</sup>*Snow v. Commissioner*, 416 U.S. 500, 503-504 (1974).

<sup>14</sup>*See Kantor v. Commissioner*, 998 F.2d 1514, 1518 (9th Cir. 1993) (“The taxpayer must demonstrate a ‘realistic prospect’ of subsequently entering its own business in connection with the fruits of the research, assuming that the research is successful”); *see also Zink v. United States*, 929 F.2d 1015, 1023 (5th Cir. 1991); *Spellman v. Commissioner*, 845 F.2d 148, 149-150 (7th Cir. 1988); *Staubert v. Commissioner*, T.C. Memo. 1992-128; *Diamond v. Commissioner*, 92 T.C. 423, 439 (1989), *aff’d*, 930 F.2d 372 (4th Cir. 1991).

<sup>15</sup>*See Kantor*, 998 F.2d at 1518-1519 (holding that the partnership possessed neither “the objective intent nor the capacity of entering such a business” at the time it incurred research expenditures); *Diamond*, 930 F.2d at 375 (“The question is not whether it is possible in principle, or by further contract, for [the taxpayer] to engage in a trade or business, but whether, in reality, the [taxpayer] possessed the capability in the years before the court to enter into a new trade or business in connection with the ‘products being developed’”); *Glassley v. Commissioner*, T.C. Memo. 1996-206, Doc 96-12999, 96 TNT 86-10 (denying section 174 deductions for expenditures to develop jojoba plants and seeds because taxpayer had neither intent nor capability to enter jojoba farming business).

<sup>16</sup>*Saykally v. Commissioner*, T.C. Memo. 2003-152, Doc 2003-13075, 2003 TNT 102-11, *aff’d*, 247 F. App’x 914 (9th Cir. 2007).

<sup>17</sup>*See Kilroy v. Commissioner*, T.C. Memo. 1980-489 (permitting deductions when actions, over a period of years, relating to inventing activities suggested taxpayers were engaged in the trade or business of inventing); *Louw v. Commissioner*, T.C. Memo. 1971-326 (1971) (permitting deductions since taxpayer’s freelance inventive activities were of sufficiently sustained character to qualify as engaging in a trade or business of an inventor); *see also Avery v. Commissioner*, 47 B.T.A. 538, 542 (1942) (permitting business deductions when taxpayer “held the patents [to his inventions] for sale or license to others for profit”).

<sup>18</sup>*See Kilroy*, T.C. Memo. 1980-489 (“numerous patents”); *Avery*, 47 B.T.A. at 540 (“about a dozen patents”). *But see Cleveland v. Commissioner*, 297 F.2d 169, 173 (4th Cir. 1961) (deeming a single invention held by a joint venture to be sufficient).

<sup>19</sup>Section 174 does not apply to copyright creation expenses because those expenses do not constitute “research and experimental expenditures” within the meaning of section 174. *See* reg. section 1.174-2(a)(1)-(3). Section 162 generally does not apply to copyright creation costs because the code requires such costs to be capitalized. Section 263(a), 263A(a)-(b); reg. section 1.263(a)-4.

<sup>20</sup>Section 263A(h).

<sup>21</sup>Under a long-standing administrative ruling, software development costs are treated the same (currently deductible) regardless of whether the software is protected by patent, copyright, or trade secret. *See* Rev. Proc. 69-21, 1969-2 C.B. 303, *updated by* Rev. Proc. 2000-50, 2000-2 C.B. 601, Doc 2000-31079, 2000 TNT 233-11, *modified and superseded by* Rev. Proc. 2007-16, 2007-1 C.B. 358, Doc 2006-25669, 2006 TNT 248-9.

<sup>22</sup>As a general rule, the government allows taxpayers to deduct advertising costs currently even though advertising often produces benefits that continue well beyond the current tax year. *See* Rev. Rul. 92-80, 1992-2 C.B. 57; *RJR Nabisco Inc. v. Commissioner*, T.C. Memo. 1998-252, Doc 98-21920, 98 TNT 131-5 (allowing trade dress and copyright development costs incurred in an advertising campaign to be deducted).

copyrighted software and graphic designs and package designs used in advertising.

In short, legislative and administrative exceptions to the general asset capitalization rule produce different tax results depending on the status (individual or corporation) of the copyright creator and in some cases, on the nature of the property embodying the copyright. The result in the example is that ABC cannot currently deduct its copyright creation costs, but EFG and XYZ may. Ironically, the value produced in each case lies not in the different tangibles embodying the copyrights, but in the intangible copyright protections themselves.<sup>23</sup> Nevertheless, even though the copyright protections are identical in each case, the tax consequences to the corporate creators differ significantly.

### Unequal Tax Treatment of IP Acquisition

Inequities in the tax treatment of intellectual property acquisition costs are also prevalent. Under the current tax system, the costs of acquiring intellectual property must first be capitalized<sup>24</sup> and then are subject to numerous irrational tax depreciation rules.<sup>25</sup> The methods and periods for recovering capitalized intellectual property acquisition costs vary by the type of intellectual property acquired, the manner of procurement, and even the method of payment. The depreciation rules for intellectual property raise some equity concerns, as illustrated in the two examples that follow.

**Example 3: Patent Purchase for Lump Sum Payment.** Individual A purchases a patent for \$100 as part of the acquisition of a business. Individual B purchases a similar patent for \$100 (not part of the acquisition of a business).

Prescribed cost-recovery periods for intellectual property range from three to 15 years, depending on the type of intellectual property acquired and the manner of procurement: 15 years for all acquired trade secrets, trademarks, and trade names<sup>26</sup>; 15 years for patents, copyrights, and computer software acquired with a trade or business<sup>27</sup>; five years

for separately acquired musical copyrights<sup>28</sup>; and three years for separately acquired computer software.<sup>29</sup> A fixed recovery period is not prescribed for patents and copyrights acquired separately.<sup>30</sup> Instead, the capitalized costs of these assets are recovered using one of two approaches: (1) over their estimated useful lives under the straight-line method, or (2) as income is actually earned from exploiting the asset under the income-forecast method (which has a maximum write-off period of 11 years).<sup>31</sup>

Under this framework, Individual A's patent acquired as part of a business acquisition is subject to ratable 15-year amortization (which may be shorter or longer than the actual useful life of the patent), but Individual B's patent acquired separately benefits from more rapid depreciation allowances (shorter useful life under the straight-line method or accelerated allowances under the income-forecast method).

The disparate tax treatment between A and B raises some interesting questions: Is it logical that all patents — regardless of type or remaining useful life — acquired along with a business are grouped into a single category with the same recovery method and period, while patents acquired separately are depreciated using an asset-by-asset approach? If patents derived their value from their relationship to a product, service, or goodwill of a

<sup>28</sup>Section 167(g)(8)(A), amended by the Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222 (providing that a taxpayer may elect to ratably deduct the costs of acquiring any musical composition or any copyright regarding musical composition property over a five-year period instead of using the income-forecast method). Note the election does not apply for any tax year beginning after December 31, 2010. Section 167(g)(8)(E).

<sup>29</sup>Section 167(f).

<sup>30</sup>Section 197(e)(3)-(4).

<sup>31</sup>For patents and copyrights acquired outside the context of a business acquisition, tax depreciation rules that were applicable before 1993 generally continue to apply. Section 167; reg. section 1.167(a)-3(a) and -14(c). Under the income-forecast method, the depreciation allowance in any given year is computed by multiplying the original acquisition cost by a fraction, the numerator of which is income from the intellectual property for the tax year and the denominator of which is forecasted total income to be earned in connection with the intellectual property during its useful life. See Rev. Rul. 60-358, 1960-2 C.B. 68, supplemented by Rev. Rul. 64-272, 1964-2 C.B., supplemented by Rev. Rul. 79-285, 1979-2 C.B. 91. In 1997 Congress codified the income-forecast method of depreciation in section 167(g), providing a maximum recovery period of 11 years for income-forecast property. Section 167(g), amended by the Small Business Job Protection Act of 1996, P.L. 104-188. Forecasted total income includes all income the taxpayer reasonably believes will be earned during the 11-year period beginning with the year the property is placed in service. Section 167(g)(1)(A) and (g)(5)(A). In the 11th year, a taxpayer may deduct any unrecovered costs left in the property. Section 167(g)(1)(C).

<sup>23</sup>Copyright owners enjoy the exclusive right to make copies, prepare derivative works, distribute the copyrighted work, and publicly perform and display the work. See *Sony Corp. of America v. Universal City Studios Inc.*, 464 U.S. 417, 432-433 (1984).

<sup>24</sup>Section 263; reg. section 1.263(a)-4(b)(1)(i) and -4(c)(1) ("A taxpayer must capitalize amounts paid to another party to acquire any intangible [property] from that party in a purchase or similar transaction").

<sup>25</sup>Sections 197 and 167. For a critique of the tax system's treatment of intellectual property acquisitions, see Nguyen and Maine, "Acquiring Innovation," 57 *Am. U. L. Rev.* 775 (2008).

<sup>26</sup>Section 197(a) and (d)(1)(F); reg. section 1.197-2(b)(5).

<sup>27</sup>Section 197(a) and (d)(1)(C)(iii); reg. section 1.197-2(b)(5).

business, as do trademarks or trade names, it might be justifiable to provide an arbitrary recovery period to avoid messy valuation and intangible asset allocation problems. However, the value of a patent acquired as part of the purchase of a trade or business is not necessarily tied to the goodwill of the acquired trade or business.<sup>32</sup> Rather, patents can be freely sold, assigned, or transferred without associated goodwill or other business assets. The same is true of copyrights.

We believe that the depreciation schedule for patents, copyrights, and software need not necessarily parallel the arbitrary depreciation schedule applicable to intangibles acquired in a business acquisition that lack inherent value (such as trademarks and trade names). Indeed, an argument could be made that if two patents or two copyrights are capable of reasonable valuation and have relatively similar commercial lives, they should be subject to similar tax rules no matter how acquired.

**Example 4: Patent Purchase for Contingent Payments.** ABC Inc. purchases a patent that has a remaining legal life of 18 years, as part of the acquisition of a trade or business. XYZ Inc. purchases a similar patent, which was not acquired as part of the acquisition of a business. Both ABC Inc. and XYZ Inc. agree to pay their respective transferors contingent payments under identical, agreed-on formulas.

As consideration, intellectual property buyers may make upfront principal payments, installment payments of a fixed amount, payments contingent on exploitation of the intellectual property, or use any combination of these. When contingent payments are made, depreciation rules differ depending on whether the intellectual property is acquired with a trade or business or acquired separately. Under current tax rules, if a contingent payment is made for a patent acquired with a business, the contingent amount is written off over a 15-year period.<sup>33</sup> If, however, a contingent payment is made for a patent acquired separately, the contingent

amount is fully deductible in the year paid.<sup>34</sup> As can be seen, ABC Inc. and XYZ Inc. in the example above are treated vastly different for tax purposes, even though both appear to be similarly situated.

The apparent rationale behind permitting an immediate deduction for separately acquired patents is that each contingent payment reflects the annual cost of the patent and a current deduction properly matches expenses with income.<sup>35</sup> However, the same policy can support deductions for all contingent payments, regardless of whether the patent is acquired separately or with a trade or business. Any concerns about valuing intangibles acquired in a business acquisition or allocating the purchase price among acquired intangibles should be nonexistent when contingent payments are involved.

### Unequal Tax Treatment of IP Dispositions

Like the taxation of intellectual property development and acquisition costs, the tax treatment of intellectual property transfers raises several equity concerns. Consider examples 5-8 below.

**Example 5: Patent Assignment.** Individual A, a freelance inventor, sells one of his many developed patents to a third party for \$100. XYZ Inc., a small research company that conducts its own research, sells one of its many developed patents to a third party for \$100.

Although one would expect the tax system to treat Individual A and XYZ Inc. similarly, that is not the case. Individual A's gain will be treated as capital gain under the section 1235 safe-harbor provision, while XYZ Inc.'s gain will be treated as ordinary income under the code's general characterization provisions.<sup>36</sup>

Section 1235 requires that the transferor be a statutorily defined holder of the patent — that is, any individual whose personal efforts created the patent property — to be guaranteed capital gains

<sup>32</sup>Trademarks, in part, derive their value from goodwill. See 1 J. Thomas McCarthy, *Trademarks and Unfair Competition*, sections 2:18-19 (4th ed. 2008). The value of patents, however, stems from the owner's ability to "exclude others from making, using, selling, or offering for sale the invention within the United States" for a set number of years. 5 Donald S. Chisum, *Chisum on Patents*, section 16.01 (2010).

<sup>33</sup>Reg. section 1.197-2(f)(2)(i) ("Any amount that is properly included in basis of an amortizable section 197 intangible after the first month of the 15-year period . . . and before the expiration of that period is amortized ratably over the remainder of the 15-year period").

<sup>34</sup>Under this approach, known as the variable contingent payment method of depreciation, a taxpayer adds the contingent payment to the basis of the patent and then immediately takes a depreciation deduction for an equal amount. The government has sanctioned the variable contingent payment method. See reg. section 1.167(a)-14(c)(4); see also *Associated Patentees Inc. v. Commissioner*, 4 T.C. 979, 985-987 (1945), acq., 1959-2 C.B. 3; Rev. Rul. 67-136, 1967-1 C.B. 58 (following the *Associated Patentees* decision).

<sup>35</sup>*Associated Patentees*, 4 T.C. at 986 (concluding that a current deduction for the entire contingent payment gives the taxpayer "a reasonable, and not more than a reasonable," depreciation allowance).

<sup>36</sup>Section 1222 (requiring the sale or exchange of a capital asset for preferential capital gains treatment), section 1221(a)(1) (excluding inventory from the definition of capital asset), and section 1231(b)(1)(A) (excluding inventory from the definition of quasi-capital asset).

treatment.<sup>37</sup> In this example, Individual A can qualify for capital gains treatment under section 1235 even though the subject of the sale (the inventory being sold) is not considered a capital asset under general characterization principles.<sup>38</sup> XYZ Inc.'s assignment, however, will not qualify for section 1235 treatment but will instead be treated as a sale of a noncapital asset yielding ordinary income. Although corporations do not get lower rates on their capital gains, these gains can be used by corporations to absorb capital losses that the corporations may have.<sup>39</sup>

Section 1235 was enacted in 1954 with section 174 primarily to encourage research activity and stimulate economic growth and technological development.<sup>40</sup> So why does section 1235 provide statutory assurance to individuals, but not corporations, that the sale of their patents will produce capital gains?

**Example 6: Copyright Assignment.** A songwriter sells one of his copyrighted songs for \$100. A painter sells one of his copyrighted paintings for \$100.

Songwriters are subject to capital gains tax rates on the sales of their songs, rather than to higher personal income tax rates, because of a special code provision enacted in 2006 governing musical compositions and the copyrights on them.<sup>41</sup> Peculiarly, capital gains treatment is not available to other individual artists such as novelists, painters, sculptors, and designers because of the general rule enacted in 1950 that inventory and self-created works are not capital assets.<sup>42</sup> Thus, the copyright creators in this example are treated vastly different for tax purposes even though the intangible legal protections assigned are similar.

Special capital gains treatment for songwriters was a result of pressure from the country music

industry.<sup>43</sup> Apparently, songwriters make on average about \$4,700,<sup>44</sup> less money than other artists, and presumably need the benefit of a reduced capital gains rate (currently 0 percent at that level of income from songwriting). The problem with this thinking is that \$4,700 of income is below the level at which any federal income tax is required; also, many songwriters have multimillion-dollar incomes that now enjoy a maximum 15 percent capital gains rate (in contrast to the current top rate on ordinary income of 35 percent). As Prof. Calvin Johnson has recently argued as part of the Shelf Project, this is unfair.<sup>45</sup>

**Example 7: Copyright Assignment.** Individual A sells copyrighted software that she created for \$100. XYZ Inc. sells similar copyrighted software that was created by its employees for \$100.

Although individual copyright creators have ordinary gain on the sale of their works (with the exception of musical copyrights, as noted above), corporate copyright creators may be eligible for capital gains treatment on the sale of works created by their employees and individual contractors.<sup>46</sup> This additional distinction arises because some authority suggests the capital-asset exception for self-created property does not apply to non-individual creators, such as corporations, the employees or independent contractors of which created the copyrights.<sup>47</sup> These distinctions, like those identified in the examples above, seem to lack any theoretical justification.

**Example 8: Intellectual Property Charitable Donation.** ABC Inc. donates intellectual property worth \$100 to a large university that will use the intellectual property in ways that will directly generate income. XYZ Inc. donates similar intellectual property worth \$100 to a small college that emphasizes education and basic research.

Before 2004 the tax code would have granted both companies an initial tax deduction for the

<sup>37</sup>Section 1235(a) and (b)(1); reg. section 1.1235-2(d)(1)(i). An original inventor's employer would not qualify as a holder "even though he may be the equitable owner of the patent by virtue of an employment relationship with the inventor." S. Rep. No. 83-1622, at 423 (1954).

<sup>38</sup>Section 1221(a)(1) (excluding from capital asset definition inventory and inventory-like property).

<sup>39</sup>Section 1211(a).

<sup>40</sup>See S. Rep. No. 83-1622, at 439 (1954) (stating that a policy goal underlying section 1235's enactment was "to provide an incentive to inventors to contribute to the welfare of the Nation").

<sup>41</sup>Section 1221(b)(3).

<sup>42</sup>Section 1221(a)(3) (excluding self-created copyrighted works from the definition of capital asset); section 1231(b)(1)(C) (excluding self-created copyrighted works from the definition of section 1231 property).

<sup>43</sup>Brody Mullins, "Music to Songwriters' Ears: Lower Taxes — Country Artists' Group Presses Lawmakers to Slash the Levy on Lyricists," *The Wall Street Journal*, Nov. 29, 2005.

<sup>44</sup>*Id.* (2005 estimates).

<sup>45</sup>Calvin H. Johnson, "Cleaning Compensation for Services Out of Capital Gain," *Tax Notes*, Jan. 11, 2010, p. 233, *Doc 2009-27878*, 2010 TNT 9-5.

<sup>46</sup>Sections 1221 and 1222.

<sup>47</sup>See Rev. Rul. 55-706, 1955-2 C.B. 300, *superseded by* Rev. Rul. 62-141, 1962-2 C.B. 181 (applying inventory exclusion, but not copyright exclusion, suggesting that the copyright exclusion does not apply to works-for-hire creations); see also *Desilu Prods. Inc. v. Commissioner*, T.C. Memo. 1965-307 (same).

same amount — the fair market value of the donated property.<sup>48</sup> As a result of amendments in 2004, however, the code does not grant either company an FMV deduction in the year of the gift.<sup>49</sup> Under current rules, the initial deduction for charitable gifts of any type of intellectual property is typically the property's tax basis. Often the donor's tax basis in intellectual property is very small; in many cases, the donor's basis is zero because development costs were deducted when incurred.<sup>50</sup>

But that's not the end of the story. To encourage charitable giving of intellectual property, Congress deemed it appropriate to grant donors of intellectual property future charitable deductions based on the income received by the donee charity.<sup>51</sup> Specifically, the donor can take a deduction for up to 10 years for gifts of royalty-producing intellectual property to public charities, but the amount of the charitable deduction declines over time.<sup>52</sup>

In this example, ABC Inc. will enjoy future charitable tax deductions equal to a percentage of the royalty income earned by its chosen donee, the commercially driven university. Because the small college's use of XYZ Inc.'s donated intellectual property will not directly generate income, XYZ Inc. will receive no tax benefit for its charitable gift. In practice, charitable deduction rules favor intellectual property used in applied research over similar intellectual property used for fundamental or purely scientific research, and favor donors who give to donees with the physical facilities, financial resources, and personnel capability to exploit intellectual property solely for direct financial results.<sup>53</sup>

### Conclusion

Intellectual property is subject to many tax inequities throughout its life cycle (development, acquisition, and transfer). Many of these inequities encourage intellectual property developers, purchasers, and assignors to plan transactions that minimize taxes. For example, if a taxpayer identifies a business's patent that it would like to purchase for contingent payments, the taxpayer receives greater immediate tax deductions if it can negotiate the purchase of the patent separately from the seller's other business assets.<sup>54</sup> Further, a taxpayer planning to donate income-generating intellectual property to a charity will receive larger tax deductions if it

donates the property to a donee that can use the intellectual property in ways that will directly generate income rather than to a non-commercially driven donee.<sup>55</sup> These decisions should be tax neutral, but under the present tax system, they are not. An optimal intellectual property tax system would not interfere with intellectual property owners' economic behavior and would avoid dead-weight losses caused by the restructuring of intellectual property transactions to minimize taxes.<sup>56</sup>

Several explanations can be offered for the unequal tax treatment of intellectual property. First, tax inequities may be inevitable because of the unique nature of intangible intellectual property rights. Compared with land, for example, intellectual property rights involve such a broad range of economic activities that no two taxpayers will be situated similarly. Second, tax inequities may result when the tax system does not adequately respond to changing intellectual property policies and the realities of today's economy. Tax rules enacted in the 1950s, for instance, may not adequately recognize the evolution of intellectual property, the emergence of new intellectual property forms, and modern intellectual property practices and trends. Third, tax inequities may be intentional. The design of any tax system involves trade-offs between varying tax policy goals. Thus, to achieve administrative efficiencies or to promote economic growth, the government may decide inequities are justifiable.

A plausible explanation for many of the inequities identified in this report may be that tax rules governing intellectual property evolved in the absence of an appropriate legal framework for the intersection of the intellectual property and taxation schemes — one that considers the soundness of tax distinctions. Special tax rules governing intellectual property evolved slowly and separately from substantive intellectual property laws, and were designed chiefly to enhance administrative efficiencies by resolving dissonance that occurred when traditional principles of taxation were used to resolve early tax disputes.<sup>57</sup> An appropriate legal framework for intellectual property taxation might consider the following questions: Should the status of intellectual property owners (individuals versus corporations) dictate tax results? Should the methods of payment (lump sum versus contingent

<sup>48</sup>Reg. section 1.170A-1(c); Rev. Rul. 58-260, 1958-1 C.B. 126.

<sup>49</sup>Section 170(e)(1)(B)(iii), amended by American Jobs Creation Act of 2004, P.L. 108-357.

<sup>50</sup>See *supra* examples 1-2.

<sup>51</sup>Section 170(m).

<sup>52</sup>*Id.*

<sup>53</sup>For a critique of the 2004 changes, see Nguyen and Maine, "Giving Intellectual Property," 39 *U.C. Davis L. Rev.* 1721 (2006).

<sup>54</sup>See *supra* Example 4.

<sup>55</sup>See *supra* Example 8.

<sup>56</sup>Graetz and Schenk, *supra* note 4, at 29 (stating that efficiency requires a tax to interfere as little as possible with people's economic behavior); Elkins, *supra* note 9, at 47 (stating that efficient taxes minimize dead-weight losses caused by taxpayer actions to reduce tax burden by choosing courses of action that minimize tax).

<sup>57</sup>See Nguyen and Maine, *supra* note 3.

## COMMENTARY / VIEWPOINTS

payments) in intellectual property transfers matter in determining tax outcomes? And should the nature of the tangible property embodying intangible intellectual property rights (book versus song) be relevant, or should tax results be determined based solely on the nature of intellectual property rights involved?

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