Abstract: The article critiques the federal income tax regime governing intellectual property using normative criteria in evaluating taxes: equity and efficiency. Identifying numerous inequities and inefficiencies in the tax system’s treatment of intellectual property, the article argues that a rational and coherent legal framework is necessary for intellectual property tax rules. The article suggests that an appropriate framework should consider the extent to which the tax system should be in harmony with the intellectual property system, establish the basis for rational tax distinctions, if distinctions are to be adopted, and reconcile tax treatments of intangible and tangible capital.

I. INTRODUCTION

Intellectual property assets are integral to U.S. business. Companies, large and small, spend a great amount of resources to create

1 Consider, for example, Intellectual Ventures, a $5 billion startup company founded in 2000, which has a patent portfolio of 27,000 patents. See Nigel Page, IV Shifts Gears, INTELLECTUAL ASSET MANAGEMENT, July-August 2009, available at http://intellectualventures.com/docs/IV-shifts-Gears-IAM-May-2009.pdf (reporting the strategies of acquiring and creating inventions by Intellectual Ventures in the United States and five Asian countries). The company accumulates patents from individuals, companies, and its own laboratory in Bellevue, Washington, in a wide range of fields to serve its numerous purposes, among them, the monetization of intellectual property. Id. (discussing Intellectual Ventures’s monetization of intellectual property by employing innovative business models). Intellectual Ventures handsomely collects royalties from companies that use any of its patented inventions. See Brier Dudley, Bellevue Lab Is An Inventor’s Real Dream, THE SEATTLE TIMES, May 27, 2009, available at http://seattletimes.nwsource.com/cgi-bin/PrintStory.pl?document_id=2009266390&zsection_id=2003907475&slug=intvent70&date=20090527. As of 2008, the company collected $1 billion in royalties. It is now one of the top twenty-five research institutions in the United States and top fifty in the world based on annual patent productivity. Id. Intellectual Ventures provides financing to many companies and research universities to continue their invention productivities, and, in return, Intellectual Ventures gains the ownership or exclusive rights in patented inventions. See Page, supra.
and develop products and services that are covered by patents, copyrights, trade secrets, and trademarks.\textsuperscript{2} If they lack the expertise, the facilities, financing, and time, they license the various intellectual property rights from others to operate their businesses; segmentation is the business \textit{modes operandi}. Multinational companies shuffle and migrate their intellectual property assets to favorable state and foreign jurisdictions for tax, employment, and productivity reasons. Some companies leverage their intellectual property assets for financing, while others leverage for litigation purposes. As intellectual property assets are highly valuable, companies seek different forms of intellectual property that are available to protect their particular products or services, bundling multiple intellectual property rights.

The importance of intellectual property to the U.S. economy underscores the need for a sound U.S. tax policy governing intellectual property rights. The federal tax system can be designed to either support or hinder intellectual property goals. Presently, the Internal Revenue Code ("Code") contains several special rules governing intellectual property.\textsuperscript{3} Some of the special tax provisions affect a large group of intellectual property assets.\textsuperscript{4} Most, however, are mutually exclusive, and affect only specific types of intellectual property.\textsuperscript{5} Many of these special tax rules governing intellectual property were designed to address early problems


\textsuperscript{3} Unless otherwise noted, all references to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended.

\textsuperscript{4} See, e.g., I.R.C. §§ 168(g), 170(e)(1)(B)(iii), (m), 197.

encountered when intellectual property transactions were analyzed under the traditional principles of taxation. But many of the special tax rules are circumscribed in ways that relegate the tax analysis back under general tax principles. Thus, the current income tax system governing intellectual property is a mixture of special rules and traditional principles of taxation.

This article evaluates the current U.S. income tax regime governing intellectual property focusing on two traditional criteria used in evaluating tax systems: tax fairness and efficiency.

Part II of this article explores whether the current tax scheme governing intellectual property is fair. The tax application of fairness is usually described in terms of the principles of horizontal and vertical equity. Horizontal equity requires that persons who are similarly situated should be taxed in a similar fashion; vertical equity dictates that persons whose situations are different should be taxed differently. A related concept of equity is that economically equivalent activities should be taxed in the same manner even though they may differ in form.

Some modern tax theorists have challenged the virtue of horizontal equity in tax policy analysis, contending that horizontal equity lacks independent significance and is devoid of any normative content. Critics

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6 See Xuan-Thao Nguyen & Jeffrey A. Maine, *The Dissonance Between Intellectual Property and Taxation* (forthcoming) (analyzing the development of special tax rules governing intellectual property in terms of their legislative purpose).


8 See Jeffrey H. Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity*, 57 Hastings L.J. 645 (2005-2006) (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”; non-parallelism “results in disparate tax treatment of taxpayers who occupy similar positions”); Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 Va. Tax. Rev. 39, 49 (1996-1997) (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,” and using the term “nonuniform taxation” to refer “to tax rules that vary by type of income or type of taxpayer”).

who question the utility of horizontal equity in evaluating tax rules often point to the difficulty in determining relevant likeness (i.e., proper comparisons of taxpayers and economic activities).\textsuperscript{10} This would seem particularly apropos with respect to intangible intellectual property rights. For example, should a person selling a literary copyright and a person selling a musical copyright be treated as equals for tax purposes? Should a purchaser of a domain name functioning as a trademark be considered equal to a purchaser of a generic domain name? Critics of horizontal equity argue that requiring equal treatment for equals merely begs the question of what are equals. But this criticism rests on an “exaggerated view of the level of precision required in order for equality to have meaning.”\textsuperscript{11} As noted by one commentator, “horizontal equity is concerned with individuals who are ‘similarly situated,’ not with those who are ‘identically situated.’”\textsuperscript{12} Even if the criticism is accepted, horizontal equity could nevertheless be viewed as a useful tool to uncover potential problems in a tax system.\textsuperscript{13} For example, the fact that two intellectual property owners who appear to be in similar economic circumstances are treated differently for tax purposes might signal that the

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\textsuperscript{10} Kaplow, A Note, supra note 9, at 192-93; McDaniel & Repetti, supra note 9, at 612-13. \textit{But see} Musgrave, A Further Note, supra note 9, at 359. \textit{See} Zolt, supra note 8, 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.”).

\textsuperscript{11} John A. Miller, \textit{Equal Taxation: A Commentary}, 29 Hofstra L. Rev. 537, 545 (2000-2001) (“All of our major tax schemes have found ways to determine likeness (or difference) that are generally recognized as fair.”).

\textsuperscript{12} David Elkins, \textit{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.”).

\textsuperscript{13} \textit{See} Kahn, supra note 8, at 651.
intellectual property tax system contains a flaw or at least challenge us to justify disparate treatment. Horizontal equity was once regarded as the primary goal of tax policy, and recent defenders of horizontal equity have proffered valid arguments that equity remains an important principle of tax theory that cannot be dismissed. To that end Part II of this article uses horizontal equity in evaluating the current tax scheme governing intellectual property, identifying differences in tax treatment of what appear to be similar intellectual property transactions. Part II highlights the need for a normative framework for intellectual property taxation that establishes a basis for rational tax distinctions among intellectual property if distinctions are to be maintained.

Part III of the article attempts to identify inefficiencies in the current intellectual property tax scheme. This is not an easy tax, as efficiency, in tax theory, has been measured by contradictory standards and means various things in various contexts. Efficiency can be viewed

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14 Some critics also question the use of horizontal equity to analyze tax expenditures (i.e., tax credits and deductions), arguing that “a tax expenditure is a subsidy that occurs outside of traditional tax equity analysis.” McDaniel & Repetti, supra note 9, at 621. But see Miller, supra note 11. In the context of home ownership, Professor Miller argues that horizontal equity analysis can actually challenge us to justify disparate treatment between homeowners and renters caused by the mortgage interest deduction. Id. at 537-38. Likewise, in the context of intellectual property ownership, horizontal equity analysis can challenge us to justify disparate tax treatment that exists between individual patent and copyright creators and corporations whose employees invent or create.

15 See, e.g., 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.”); 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.”). See also Joseph T. Sneed, The Criteria of Federal Income Tax Policy, 17 Stan. L. Rev. 567 (1965).

16 See, e.g., Samuel A. Donaldson, The Easy Case Against Tax Simplification, 22 Va. Tax Rev. 645 (2002-2003) (arguing equity and efficiency, as opposed to simplicity, are core values); Elkins, supra note 12 (showing independence of horizontal equity as a principle of tax theory); Brian Galle, Tax Fairness, 65 WASH. & LEE. L. REV. 1323, 1336 (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 8 (recognizing 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 11 (discussing the merits of horizontal equity analysis).

17 See MILLER & MAINE, supra note 7, at 4; see also GRAETZ & SCHENK, supra note 7, at 29-30 (summarizing various meanings of the efficiency criterion).
as a utilitarian concept requiring that we should seek a balance between maximizing tax revenues and minimizing the social costs of taxation.\textsuperscript{18} Under this efficiency standard, an optimal intellectual property tax system would be neutral (i.e., it would not interfere with intellectual property owners’ economic behavior and would avoid deadweight losses caused by taxpayers’ restructuring of intellectual property transactions to minimize taxes.\textsuperscript{19} But the usefulness of this standard in evaluating the intellectual property tax system is questionable since most tax rules governing intellectual property are deliberately non-neutral and would be viewed as having high efficiency costs. Many of the special tax provisions governing patents and copyrights, for example, were a deliberate attempt to support the social utility mandate of the patent and copyright laws.\textsuperscript{20} At least with respect to the intellectual property tax scheme, neutrality violations are inevitable to achieve more important intellectual property social engineering policies and advance the public interest.

An appropriate measure of efficiency in intellectual property taxation might focus on gains to society. Indeed, some commentators describe efficiency in terms of economic growth.\textsuperscript{21} Under this standard, the intellectual property tax system would be viewed as efficient if it promoted economic growth; the tax system would be inefficient if it inhibited such growth. Under this meaning of efficiency, tax subsidies (i.e., tax expenditures in the form of deductions and credits) for certain

\textsuperscript{18} See Miller & Maine, supra note 7, at 4; Edward A. Zelinksy, Efficiency and Income Taxes: The Rehabilitation of Tax Incentives, 64 Tex. L. Rev. 973, 978-1012 (1986); Harman P. Ayayo, Tax Expenditures: Useful Economic Concept or Budgetary Dinosaur?, 93 Tax Notes 1152 (Nov. 26, 2001); Zolt, supra note 8, at 63 (Efficient taxes distort as little as possible”; describing three forms in which distortions come).

\textsuperscript{19} Graetz & Schenk, supra note 7, at 29 (stating that efficiency requires that a tax interfere as little as possible with people’s economic behavior); Elkins, supra note 12, at 47 (stating that efficient taxes minimize deadweight losses caused by taxpayer actions to reduce tax burden by choosing courses of action that minimize tax); Zolt, supra note 8, at 63 (stating that efficient taxes distort as little as possible).

\textsuperscript{20} Tax expenditures in the form of deductions and credits for certain research and development, and short write-off periods for certain intellectual property acquisitions, were deliberately designed to drive economic decision-making to achieve more important intellectual property social policies. Whether tax expenditures (i.e., deductions and credits used to influence behavior) represent sound tax policy has been the subject of much debate. See, e.g., Zelinksy, supra note 18; Ayayo, supra note 18.

\textsuperscript{21} Graetz & Schenk, supra note xx, at 29 (“The efficiency criterion sometimes has other meanings. A tax often is said to be efficient when it promotes economic growth and inefficient when it inhibits such growth.”); Edward Yorio, The President’s Tax Proposals: A Major Step in the Right Direction, 55 Fordham L. Rev. 395 (1987).
intellectual property activities might upset the free market allocations of capital, but might be justified because the targeted activities involve significant beneficial externalities.\textsuperscript{22} And if these subsidies correctly quantified society’s interests, they would be seen as contributing to market efficiency.\textsuperscript{23} Thus, Part III of this article evaluates numerous tax subsidies for intellectual property to assess whether they adequately promote economic growth. It is argued that too often tax expenditures for intellectual property are circumscribed in ways that limit their effectiveness, and, hence, do not optimally contribute to efficiency in the market.

The design of any tax system involves tradeoffs between equity and efficiency principles.\textsuperscript{24} For example, it may be efficient to provide tax breaks to certain innovators because society as a whole benefits from high innovation via encouragement of individual effort by personal gain.\textsuperscript{25} But such measures may violate horizontal equity. Because conflicts between equity and efficiency are often inevitable, a legal framework for intellectual property tax rules should establish reasonable tradeoffs.\textsuperscript{26} A framework, for example, might decide whether to grant equity primacy over efficiency or vice versa.\textsuperscript{27} If inequity gives way to efficiency, the

\textsuperscript{22} Under this efficiency standard, the tax system might be said to be efficient even if neutrality violations upset the free market allocations of capital. For example, if policymakers chose to adopt a lower tax on patent owners vis-a-vis copyright owners to stimulate the economy, capital might flow from the copyright segment to the patent segment as a result of the tax change.

\textsuperscript{23} Elkins, \textit{supra} note 12, at 48 (“Where the economic activity concerned produces beneficial externalities, a negative tax (i.e., a subsidy) may be offered. . . . When the subsidy correctly quantifies society’s interests, it actually contributes to the efficiency in the market.”).

\textsuperscript{24} See \textit{id.} (arguing efficiency is not necessarily horizontally equitable); Miller, \textit{supra} note 11, at 541 (“Equity and efficiency principles will often coincide”); Zolt, \textit{supra} note 8, at 60 (concluding that “[t]ax issues often generate conflicts between efficiency and equity concerns”).

\textsuperscript{25} Under the contradictory efficiency standard discussed earlier, some would argue that such tax breaks to innovators violate the principle of economic efficiency by encouraging taxpayers to choose patent activities over other intellectual property activities. Under this view, the greater the inequity the greater the inefficiency.

\textsuperscript{26} Elkins, \textit{supra} note 12, at 68 (“Every tax system must allow some degree of inequality in order to encourage beneficial economic activity.”); Zolt, \textit{supra} note 8 (examining choices where unequal treatment yields efficiency gains).

\textsuperscript{27} See Zolt, \textit{supra} note 8, at 99 (stating that when “efficiency and equity may conflict,” [o]ne approach could grant primacy to equity, regardless of efficiency
framework might decide on an acceptable level of aversion to inequality (e.g., horizontal equity violations might be justified only if efficiency gains are significant).  

Part II of this paper exposes numerous inequities in the tax system’s treatment of intellectual property and Part III identifies inefficiencies in the intellectual property taxation scheme, which serve to hinder, as opposed to promote, beneficial intellectual property activity. These sections highlight the defective nature of the current tax scheme and the need for a set of rational and coherent tax rules applicable to intellectual property.

Part IV suggests that an appropriate legal framework is needed for federal tax legislation governing intellectual property, and proffers components for a possible new framework. First, a framework should consider the extent to which harmonization should be achieved between intellectual property and taxation schemes (the efficiency criterion). While the current system aims to promote the innovation goals of patents and patent-like property, it arguably hinders beneficial copyright and trademark goals. Second, a framework should establish a basis for rational tax distinctions for intellectual property if these distinctions are to be maintained (the equity criterion). The current tax system, which contains different rules for different types of intellectual property, is inflexible and not easily applied to future innovations and intellectual property movements, such as the bundling of intellectual property rights in business practice today. Finally, a framework should reconcile the tax treatments of intangible and tangible capital, since the current tax treatments are irrational.

II. EVALUATING EQUITY IN THE INTELLECTUAL PROPERTY TAX SYSTEM

Ideally, the income tax regime for intellectual property transactions should embrace the principle of fairness. Tax fairness is usually considerations”).

28 Id. at 100 (“If efficiency gains are minor, then there may be strong reasons for not adopting provisions that have inequity, or the perception of inequity. The presumption should be in favor of uniform tax treatment where gains from nonuniform treatment cannot be adequately justified. Where we can demonstrate substantial efficiency gains, rejecting proposals on equity grounds become more problematic.”).

29 See supra notes 7-16 and accompanying text.
described in terms of the principles of horizontal equity and vertical equity. Horizontal equity requires that persons who are similarly situated should be taxed in a similar fashion; vertical equity dictates that persons whose situations are different should be taxed differently. A related notion is that economically equivalent activities should be taxed in the same manner even though they may differ in form.

Unfortunately, it is difficult to evaluate a tax system governing intangible rights in terms of tax equity because it is difficult to identify similar economic activities and determine which intellectual property holders should be considered equals. Should a person selling a literary copyright and a person selling a musical copyright be treated as equals for tax purposes? Should a seller of computer software protected as a patent be viewed as similarly situated to a seller of similar computer software protected as a trade secret? Should a purchaser of a domain name functioning as a trademark be considered equal to a purchaser of a generic domain name? Is a person who donates intellectual property to a large university engaged in applied research similar to a person who donates similar intellectual property to a small college engaged in fundamental, purely scientific research?

Viewing all intellectual property owners as equals and treating them equally for tax purposes would have unarguable appeal. Consider in general the tax treatment of both patents and copyrights. The same clause of the U.S. Constitution empowers Congress to promote the progress of both science and the useful arts. In response, Congress has granted significant protections for both patents and copyrights. These legal protections are very similar in substance (e.g., grants of monopolies).

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30 U.S. CONST. art. I, § 8, cl. 8 (“The Congress shall have Power . . . To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries; . . . “).


32 Patents and copyrights share some common characteristics. They are both intangible personal property. See 1 J. THOMAS MCCARTHY, TRADEMARKS AND UNFAIR
the intellectual property system treats patents and copyrights similarly, then the design of tax rules to support the system might also treat patents and copyrights similarly so as not to violate tax notions of fairness. Of course, then one could easily point to the real substantive differences between patents and copyrights and argue that differing tax results do not violate fairness notions.

A fundamental problem with the current tax system governing intellectual property is that it is inconsistent, treating, for instance, patent and copyright owners as equals in some contexts, but treating them as unequals in other. For example, both patent and copyright acquisitions costs are treated similarly for tax purposes, as are patent and copyright

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33 Despite their similarities, there are many substantive differences between patents and copyrights. For example, the legal life of a patent is dictated under the federal patent statute and lasts twenty years from the date of patent application. 35 U.S.C. § 154(a)(2) (2009) (providing that the patent term is 20 years from an effective filing date). The legal life of a copyright under the federal copyright statute is much longer; it spans the life of the original author plus 70 years after his or her death. If the author is an entity, the life of the copyright is 120 years from the date of publication or 95 years from the date of registration, whichever expires first. 17 U.S.C. § 302 (2009); see Thomas F. Cotter, Toward a Functional Definition of Publication in Copyright Law, 92 MINN. L. REV. 1724, 1733 (2008) (reviewing the statutory provision for the legal life of a copyright created by natural authors and works made for hire).

34 See I.R.C. § 197(a), (e)(4)(C) (providing a 15-year amortization period for
donations. One difference, however, patent development costs are deductible when incurred, whereas most copyright creation costs must be capitalized. Furthermore, sales of self-developed patents are generally entitled to preferential capital gain treatment, whereas sales of most self-created copyrights generally are not.

Even if it is conceded that patent owners are different from copyright owners, two patent owners who are similarly situated, or two copyright owners whose situations are similar, should be taxed in a similar fashion under tax equity principles. This is not the case under the current tax regime governing intellectual property, raising serious equity concerns.

A. Inequities in the Tax Treatment of IP Development Costs

Since the inception of the modern, federal income tax system, the Internal Revenue Code (“Code”) has precluded a current deduction for so-called “capital expenditures,” historically viewed as any expenditure that

35 See I.R.C. § 170(a), (e)(1)(B)(iii) (limiting initial charitable contribution tax deduction to adjusted basis in donated patents and copyrights).

36 See I.R.C. §§ 174(a) (allowing taxpayers to treat research or experimental expenditures as expenses not chargeable to capital account as long as those expenditures are paid or incurred in connection with the taxpayer’s trade or business); 263(a)(1)(B) (providing that the capitalization rules under section 263(a) do not apply to research or experimental expenditures deductible under section 174(a)).

37 See I.R.C. § 263(a); Treas. Reg. § 1.263(a)-4(b)(1)(iii), -4(b)(3), -4(d)(5) (requiring capitalization of costs of obtaining rights from a governmental agency, as well as costs of creating any “separate and distinct intangible asset”). See also I.R.C. § 263A(a)-(b) (requiring capitalization of all direct and indirect expenditures incurred to produce creative properties, such as films, sound recordings, video tapes, books, and similar properties that embody the words, ideas, concepts, images, or sounds by the creators thereof). But see I.R.C. § 263A(h) (providing an exception from the capitalization requirement, permitting certain freelance writers, photographers, and artists to deduct “qualified creative expenses” that would otherwise have to be capitalized).

38 See I.R.C. § 1235 (providing statutory assurance to certain individual inventors that the sale of their patents will qualify for reduced capital gains rates).

39 See I.R.C. § 1221(a)(3) (excluding from the definition of capital asset a literary, musical, or artistic composition, or similar property held by the creator), 1231(b)(1)(C); but see I.R.C. § 1221(b)(3) (providing an exception for sales of musical compositions and copyrights in musical works).
produces an asset lasting beyond the current tax period. \textsuperscript{40} With respect to intellectual property development expenditures, though, Congress has specifically legislated specific exceptions to asset-capitalization, \textsuperscript{41} and the Service has administratively created additional exceptions. \textsuperscript{42} The following examples illustrate the inequities caused by these legislative and administrative exceptions to normative capitalization.

Consider two novice inventors (A and B) who each spend $100,000 to develop their first patented invention. Inventor A plans to enter into a future business of his own with his developed technology, marketing the technology himself. Inventor B, however, plans to license her developed technology to a company that will market the developed technology to its customers. A and B appear similarly situated; each spends $100,000, and each obtains patent protections for similar technologies that will be exploited in the commercial marketplace. Under the present tax system, however, A and B are not treated equally. A may currently deduct the $100,000 in research costs, but B may not. The disparate treatment stems from the Code which allows a current deduction only for research expenditures incurred “in connection with” the inventor's trade or business. \textsuperscript{43} A taxpayer need not be currently conducting a business (i.e., producing or selling any product) in order for research or experimental expenditures to meet the "in connection with a trade or

\textsuperscript{40} Revenue Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167 (providing “[t]hat no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property”). For the current disallowance provisions, see I.R.C. §§ 263, 263A. The reason capitalized expenditures are not currently deductible is that the property created or acquired is not consumed or used up within the year, but rather continues to contribute to income over a period of years. If the costs incurred in the creation or acquisition of such property were deductible in full in the current year, there would be a mismatching of income and expenses that produced that income; income would be understated in the year of creation or acquisition and overstated in later years. By prohibiting the immediate deduction of capital expenditures this problem is avoided.

\textsuperscript{41} See I.R.C. §§ 174 (allowing a deduction for research and experimental expenditures that would otherwise have to be capitalized), 263A(h) (allowing a deduction for qualified creative expenses incurred by freelance authors, writers, and photographers that would otherwise have to be capitalized).


\textsuperscript{43} I.R.C. § 174(a).
business" requirement; however, courts have held that a taxpayer must demonstrate a realistic prospect of entering into a trade or business in the future that will exploit the technology under development. In making this determination, the taxpayer must demonstrate both an objective intent to enter into the trade or business and the capability to perform the business.

As a general rule, the receipt of royalties alone does not constitute a trade or business. The Tax Court, in a few cases, has held that research activities and exploitation of the resulting inventions by sale or license may constitute a trade or business. However, such cases involved

44 Prior to 1974, the Internal Revenue Service ("IRS") and the courts took the position that to qualify for section 174 treatment, a taxpayer must have already engaged in a trade or business. See Best Universal Lock Co. v. Comm’r, 45 T.C. 1 (1965), acq., 1966-2 C.B. 4; Koons v. Comm’r, 35 T.C. 1092 (1961). The U.S. Supreme Court rejected this narrow approach and held that pre-operational research or experimental expenditures could qualify for the section 174 deduction. Snow v. Comm’r, 416 U.S. 500, 503-04 (1974).

45 See Kantor v. Comm’r, 998 F.2d 1514, 1518 (9th Cir. 1993) (stating that a "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. Comm’r, 845 F.2d 148, 149 (7th Cir. 1988); Stauber v. Comm’r, 63 T.C.M. (CCH) 2258 (1992); Diamond v. Comm’r, 92 T.C. 423, 439 (1989), aff’d, 930 F.2d 372 (4th Cir. 1991).

46 See Kantor, 998 F.2d at 1518-19 (holding that the partnership did not possess either the objective intent to market or the capability of marketing the developed software at the time it incurred the research expenditures); see also Glassley v. Comm’r, 71 T.C.M. (CCH) 2898 (1996) (denying section 174 deductions for expenditures to develop jojoba plants and seeds because taxpayer had neither intent nor capability to enter jojoba farming business); 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].").

47 See H.R. Rep. No. 97-201, at 113 (1981) (laying out rules for the application of section 174, but not explicitly naming licensing as a trade or business that entitles taxpayers to relief under that provision).

48 See Kilroy v. Comm’r, 41 T.C.M. (CCH) 292, 295 (1980) (permitting deductions where actions, over a period of years, relating to inventing activities suggested taxpayers were engaged in the trade or business of inventing); Louw v. Comm’r, 30 T.C.M. (CCH) 1421, 1422-23 (1971) (permitting deductions since taxpayer's free-lance inventive activities were of sufficiently sustained character to qualify as engaging in a trade or business of an inventor); Avery v. Comm’r, 47 B.T.A. 538, 542 (1942) (permitting business deductions where taxpayer sold some inventions and licensed other inventions for monetary considerations).
inventors who had developed a series of inventions.\footnote{See Kilroy, 41 T.C.M. (CCH) at 295 (six patents); Avery, 47 B.T.A. at 540 (twelve patents). But see Cleveland v. Comm’r, 297 F.2d 169, 173 (4th Cir. 1961) (one invention).} In one recent case, the Ninth Circuit affirmed a Tax Court decision that denied current deductions to a computer software developer who did not market the developed technology himself, but licensed the technology to another company for use in that company’s trade or business.\footnote{Saykally v. Comm’r, T.C. Memo 2003-152, aff’d unpublished per curiam decision, No. 05-75128 (9th Cir. 2007).} A tax rule that fails to recognize the important role of technology licensing and favors only inventive activities of a sufficiently sustained character seems unfair.

As with patent development activity, not all economically equivalent copyright creation activities are treated equally for tax purposes. As crafted, the legislative and administrative exceptions to the asset-capitalization rule produce different tax results depending on the status of the copyright creator (i.e., individual versus corporation) and, in some cases, on the nature of the property embodying the copyright. As a general rule, costs incurred in creating works that are subject to copyright protection are not currently deductible.\footnote{Section 174 does not apply to copyright creation expenses because such expenses do not constitute “research and experimental expenditures” within the meaning of section 174. See Treas. Reg. § 1.174-2(a)(1), -2(a)(2). Section 162 generally does not apply to copyright creation costs as the Code requires such costs to be capitalized. See I.R.C. § 263(a); Treas. Reg. § 1.263(a)-4 (requiring capitalization of costs of obtaining rights from a governmental agency, as well as costs of creating any “separate and distinct intangible asset”). See also I.R.C. § 263A(a)-(b) (requiring capitalization of all direct and indirect expenditures incurred to produce creative properties, such as films, sound recordings, video tapes, books, and similar properties that embody the words, ideas, concepts, images, or sounds by the creators thereof).} Congress created a narrow exception for certain costs incurred by individuals engaged in the trade or business of being a writer, photographer, or artist.\footnote{I.R.C. § 263A(h) (providing an exception from the capitalization requirement, permitting certain freelance writers, photographers, and artists to deduct “qualified creative expenses” that would otherwise have to be capitalized).} Thus, expenses incurred by an individual author in writing a book are currently 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 or certain advertising materials. As a result, a corporation may not currently deduct the costs of developing copyrighted books, films, or songs, but may currently deduct the costs of developing copyrighted software or copyrighted graphic designs and package designs used in advertising. Ironically, the value produced in each case lies not in the different tangibles embodying the copyright, but in the intangible copyright protections themselves. Even though the copyright protections are identical in each case (similar legal protections exist under federal copyright law for books or software or advertising materials), the tax consequences to the corporate creators differs significantly.

B. Inequities in the Tax Treatment of IP Acquisition Costs

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 be capitalized, and then are also subject to a host of irrational tax depreciation rules. Different methods

53 Under a longstanding administrative ruling, software development costs are treated the same (i.e., 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, superseded and updated by Rev. Proc. 2000-50, 2000-2 C.B. 601.

54 As a general rule, the government allows taxpayers to currently deduct advertising costs notwithstanding the fact that advertising often produces benefits that continue well beyond the current taxable year. See Rev. Rul. 92-80, 1992-2 C.B. 57. Only in unusual circumstances where advertising is directed toward obtaining future benefits significantly beyond those traditionally associated with ordinary product, institutional, or goodwill advertising must the costs be capitalized. Id. Advertising expenditures often encompass the costs of creating materials that are copyrighted. An interesting question is whether the long-term intangible benefits provided by copyright protection should serve as the basis for requiring capitalization of advertising campaign expenditures. Or, should such costs be deductible because they resulted from “advertising” activities? In one case, the Tax Court allowed trade dress and copyright development costs to be deducted, even though such costs in a non-advertising context would most likely have to be capitalized. See Nabisco, Inc. v. Comm’r, 76 T.C.M. (CCH) 71 (1988).

55 I.R.C. § 263; Treas. Reg. § 1.263(a)-4(b)(1)(i), -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.”).

56 In an economic sense, depreciation is the decline in value of an asset due to wear and tear and obsolescence. For tax purposes, depreciation is a deduction from income, permitting the taxpayer to recover the capitalized cost of that asset. Depreciation methods are sometimes called cost recovery systems. So, for example, if an asset used in business for five years cost a taxpayer $5,000, the taxpayer might take a $1,000 deduction each year on her taxes for five years to reflect the decline in value of that asset.
and different periods\footnote{58} of recovery of capitalized intellectual property acquisition costs are provided depending on the type of intellectual property acquired,\footnote{59} the manner of procurement,\footnote{60} and even the method of

and to reflect its contribution to the production of taxable income. The entire cost of the asset is not deducted all at once because the asset helped produce income over five years. To match the taxpayer’s expenses against the revenues they helped produce, the taxpayer must spread out the deduction over the useful life of the asset. \textit{See generally} \textsc{Miller \& Maine, supra} note 14, at 118-122.

\footnote{57} Capitalized intellectual property costs are depreciated using either the straight-line method or the income-forecast method depending on a number of factors. \textit{See I.R.C. § 197(a), (e)(3)-(4) (requiring straight-line method for intellectual property acquired in connection with the acquisition of assets that constitute a trade or business). See also I.R.C. § 167(a), (g)(8); Treas. Reg. §§ 1.167(a)-3, -14, 1.167(b)-1 (allowing either the straight-line method or the income-forecast method for intellectual property acquired separately). Accelerated or “bonus” depreciation methods that are available for depreciable tangible property are not available for intangible property. \textit{See I.R.C. § 168(b); but see I.R.C. §§ 197(e)(3), 179(a), (d)(1)(A)(ii) (permitting taxpayers to elect to deduct the cost of purchasing off-the-shelf computer software).}

Under the straight-line method, acquisitions costs are deducted ratably over the asset’s useful life or over a statutorily prescribed recovery period. Under the income-forecast method, acquisition costs are recovered as income is earned from exploitation of the patent. \textit{Rev. Rul. 60-358, 1960-2 C.B. 68, amplified by Rev. Rul. 64-273, 1964-2 C.B. 62, amplified by Rev. Rul. 79-285, 1979-2 C.B. 91}. 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 taxable year, and the denominator of which is forecasted or estimated total income to be earned in connection with the intellectual property during its useful life. \textit{Id. Consider the following example.}

In Year 1, Taxpayer purchases a patent for $100 and estimates that forecasted total income from the patent will be $200. In Year 1, the patent generates income of $80. The depreciation allowance for Year 1 is $40, computed by multiplying the acquisition cost of $100 by the fraction obtained by dividing current year income of $80 by forecasted total income of $200. Under this approach, 40% of forecasted income was earned in Year 1, so 40% of the total purchase cost was deducted in Year 1. \textit{See Treas. Reg. § 1.167(n)-4(b).}

\footnote{58} Some types of intellectual property are depreciated over an arbitrary fifteen-year period regardless of the intellectual property’s legal or useful life. \textit{See I.R.C. § 197(a)-b), (d)(1)(C)(iii), (d)(1)(F). Other types are depreciated ratably over their useful life (i.e., under the straight-line method). I.R.C. §§ 167(a), 197(e)(3)-(4); Treas. Reg. §§ 1.167(a)-3, -14; Treas. Reg. § 1.167(b)(1). Others are depreciated only as the intellectual property generates income (i.e., under the income-forecast method). I.R.C. § 167(g)(8); Treas. Reg. § 1.167(a)-14. As with the appropriate depreciation method, the appropriate recovery period depends on a number of factors.

\footnote{59} For example, trademarks, trade names, trade secrets, and know-how are depreciated over fifteen years. \textit{I.R.C. § 197(a)-(b), (d)(1)(C)(iii), (F). Patents and copyrights acquired separately are depreciated over their useful lives under either the straight-line method or income-forecast method. I.R.C. §§ 167(a), (g)(8); Treas. Reg. §§ 1.167(a)-3, -14(a). Computer software acquired separately is generally depreciated over three years. I.R.C. § 167(f).}
Prescribed recovery periods, for example, now range from three to fifteen 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, 15 years for patents, copyrights, and computer software acquired with a trade or business, 5 years for separately-acquired musical copyrights, 3 years for separately-acquired computer software. A fixed recovery period is not prescribed for patents and copyrights acquired separately; such assets are recovered over their estimated useful lives under the so-called “straight-line method,” or as income is actually earned under the so-called “income forecast method” (with a maximum write off period of 11 years).

Intellectual property may be acquired in a transaction involving the acquisition of a trade or business or may be acquired separately or with a group of assets that collectively do not constitute a trade or business. For many types of intellectual property, such as patents, patent applications, and computer software, depreciation rules differ depending on the method of procurement (i.e., section 197 applies only if these assets are acquired with a business). See I.R.C. § 197(e)(3)-(4). For other types, such as trademarks, trade names, trade secrets and know how, method of procurement is irrelevant (i.e., section 197 applies regardless of whether these assets are acquired separately or with a business). Id.

As consideration, intellectual property transferees may make up-front principal payments, installment payments of a fixed amount, payments contingent on exploitation of the intellectual property, or use any combination of these methods. When contingent payments are made, depreciation rules differ depending on whether the intellectual property is acquired separately or acquired with a trade or business. For example, if a contingent payment is made for a patent acquired with a business, the contingent amount is written off over a fifteen-year period. Treas. Reg. § 1.197-2(f)(2)(i). If a contingent payment is made for a patent acquired separately, then the contingent amount is fully deductible in the year paid. Treas. Reg. § 1.167(a)-14(c)(4).

I.R.C. § 197(a), (d)(1)(F); Treas. Reg. § 1.197-2(b)(5).

I.R.C. § 197(a), (d)(1)(C)(iii); Treas. Reg. § 1.197-2(b)(5).

I.R.C. § 167(g)(8)(A), as added by the Tax Increase Prevention and Reconciliation Act of 2005 (providing taxpayer may elect to ratably deduct the costs of acquiring any musical composition or any copyright with respect to musical composition property over a five-year period instead of using the income forecast method).

I.R.C. § 167(f).

For patents and copyrights acquired outside the context of a business acquisition, tax depreciation rules that were applicable prior to 1993 generally continue to apply. Treas. Reg. § 1.167(a)-3, -14. Thus, the capitalized costs of separately acquired patents and copyrights are recovered under one of two approaches: (1) over their useful lives under the straight-line method or (2) as income is earned under the income-forecast method. In 1997, Congress codified the income forecast method of depreciation in
Such an approach adopted by the government raises some policy concerns. For example, a patent acquired as part of the acquisition of a business is subject to ratable fifteen-year amortization (which may be shorter or longer than the actual useful life of the patent), but a 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). Is it logical that all patents, regardless of type or remaining legal life, acquired along with a business are grouped into a single category with a single recovery method and period, whereas patents acquired separately are depreciated using an asset-by-asset approach? If a patent derived its value from its relationship to a product, service, or goodwill and reputation of a business like a trademark or trade name, it might be justified to provide an arbitrary recovery period to avoid messy valuation and intangible asset allocation problems. However, a patent acquired as part of the purchase of a trade or business does not necessarily derive its value from the goodwill and reputation of the business with which it is associated. Patents can be freely sold, assigned, or transferred without associated goodwill or other business assets. The same could be said for purchases of copyrights and computer software.

The depreciation schedule for patents, copyrights, and software need not necessarily parallel the arbitrary depreciation schedule applicable to all intangibles acquired in a business acquisition, such as trademarks

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section 167(g) of the Code, providing a maximum recovery period of eleven years for income forecast property. I.R.C. § 167(g), as added by the Small Business Job Protection Act of 1996. See 1997 U.S.C.C.A.N. 908 (1997). Forecasted total income includes all income the taxpayer reasonably believes will be earned during the eleven-year period beginning with the year the property is placed in service. I.R.C. § 167(g)(1)(A), (g)(5)(C). In the eleventh year, a taxpayer may deduct any unrecovered costs left in the property. I.R.C. § 167(g)(1)(C).

67 Trademarks, in part, derive their value from goodwill. See 1 J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION §§ 2:18-19 (4th ed. 2007) (citing Mutual Life Ins. Co. v. Menin, 115 F.2d 975 (2d Cir. 1940), cert. denied, 313 U.S. 578 (1941)). 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. See 5 DONALD S. CHISUM, CHISUM ON PATENTS § 16.01 (2004).

68 See, e.g., Zenith Radio Corp. v. Hazeltine Research, Inc., 395 U.S. 100, 135 (1969) (citing Waterman v. Mackenzie, 138 U.S. 252, 255 (1891)) ("The law... recognizes that [the patent holder] may assign to another his patent, in whole or in part, and may license others to practice his invention.").
and trade names, which lack inherent value. An argument could be made that, if two patents or two copyrights or two types of computer software are capable of reasonable valuation and have relatively similar commercial lives, they should be subject to similar tax rules no matter how acquired.  

Another example of tax inequity under the current depreciation regime for intellectual property acquisitions relates to the treatment of contingent payments. Contingent payments made for patents and copyrights acquired with a business are treated vastly different from contingent payments made for patents and copyrights acquired separately. If a contingent payment is made for a patent acquired with a business, the contingent amount is written off over a fifteen-year period. If a contingent payment is made for a patent acquired separately, then the contingent amount is fully deductible in the year paid. The apparent rationale behind permitting an immediate deduction for each year's contingent payment for separately acquired patents is that each payment reflects the annual cost of the patent, and that a current deduction properly matches expenses with income. Should not the same policy be used to

69 Tax inequities with respect to software purchases are even more evident in light of the artificially short recovery period for separately acquired software. While software acquired as part of the acquisition of a business is depreciated over fifteen years, software acquired separately is depreciated over three years—a substantial tax benefit to those taxpayers who can navigate the system and negotiate for separate purchases of software. Compare I.R.C. § 197(a)-(b), (e)(3) with I.R.C. § 167(f).

70 Treas. Reg. § 1.197-2(f)(2)(i). According to the legislative history: “[I]f a portion of the cost of acquiring an amortizable section 197 intangible is contingent, the adjusted basis of the section 197 intangible is to be increased as of the beginning of the month that the contingent amount is paid or incurred. This additional amount is to be amortized ratably over the remaining months in the . . . amortization period that applies to the intangible as of the beginning of the month that the contingent amount is paid or incurred.” H.R. Rep. No. 103-213, at 685 (1993), reprinted in 1993 U.S.C.C.A.N. 1088, 1374.

71 Under this approach, known as the "variable contingent payment" method of depreciation, a taxpayer adds the amount of the contingent payments 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 Treas. Reg. § 1.167(a)-14(c)(4); see also Associated Patentees, Inc. v. Comm’r, 4 T.C. 979, 985-87 (1945), acq., 1959-2 C.B. 3 (sanctioning deduction for variable contingent payments); Rev. Rul. 67-136, 1967-1 C.B. 58 (agreeing to following the Associated Patentees decision); Allied Tube & Conduit Corp. v. Comm’r, 34 T.C.M. (CCH) 1218 (1975) (recognizing that deducting yearly payments on a patent is a reasonable method of depreciation).

72 See 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
support current 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 about allocating the purchase price among acquired intangibles should be nonexistent when contingent payments are involved.

C. Inequities in the Tax Treatment of IP Transfers

The tax treatment of intellectual property transfers raises a number of equity concerns. Consider the following example related to the assignment of two patents. Individual A, a free-lance inventor, sells one of his many developed patents to a third party for $100,000. XYZ, Inc., a small research company whose employees conduct research, sells one of its many developed patents to a third party for $100,000. 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 safe harbor provision of section 1235;\footnote{I.R.C. § 1235.} XYZ, Inc.’s gain will be treated as ordinary income under general provisions of the Code. This is due to the fact that section 1235 guarantees capital gain treatment only if the transferor is a statutorily defined "holder" of the patent—i.e., any individual whose personal efforts created the patent property.\footnote{I.R.C. § 1235(a), (b)(1); Treas. Reg. § 1.1235-2(d)(1)(i). More specifically, the regulations provide that a holder is any individual whose efforts created the patented property and who would qualify as the "original and first" inventor, or joint inventor, under the patent laws. \textit{See id.} (referring to Title 35 of the Code). An 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 439-40 (1954), \textit{reprinted in} 1954 U.S.C.C.A.N. 4621, 5082-83.} So here, Individual A can qualify for capital gain treatment under section 1235 even though the subject of the sale (inventory) is not considered a capital asset under general characterization principles.\footnote{I.R.C. § 1221(a)(1) (excluding from capital asset definition inventory and inventory-like property).} XYZ, Inc. will not qualify for section 1235 treatment, but instead will be treated as selling a non-capital asset yielding ordinary income.\footnote{Although corporations do not get lower rates on their capital gains, capital gains can be used by a corporation to absorb capital losses the corporation may have. \textit{See} I.R.C. § 1211(a) (providing that a corporation’s capital losses are allowed only to the reasonable," depreciation allowance, whereas permitting as depreciation only a proportionate part of the payment "might deny the recovery of [the taxpayer's] cost and would unquestionably result in a distortion of income").}


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73 I.R.C. § 1235.

74 I.R.C. § 1235(a), (b)(1); Treas. Reg. § 1.1235-2(d)(1)(i). More specifically, the regulations provide that a holder is any individual whose efforts created the patented property and who would qualify as the "original and first" inventor, or joint inventor, under the patent laws. See id. (referring to Title 35 of the Code). An 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 439-40 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 5082-83.

75 I.R.C. § 1221(a)(1) (excluding from capital asset definition inventory and inventory-like property).

76 Although corporations do not get lower rates on their capital gains, capital gains can be used by a corporation to absorb capital losses the corporation may have. See I.R.C. § 1211(a) (providing that a corporation’s capital losses are allowed only to the
Copyright assignments are similarly subject to different rules. For example, songwriters get to pay capital gains tax rates rather than higher personal income tax rates on the sales of their songs as a result of a special Code provision enacted in 2006 that govern musical compositions and the copyrights thereon. Peculiarly, capital gains treatment is not available to other individual artists, such as novelists, painters, sculptors, and designers. Further, although individual copyright creators have ordinary gain on the sale of their works (with the exception of musical copyrights as noted), corporate copyright creators are eligible for capital gain on the sale of their works created by employees and individual contractors. This additional distinction results from the fact that the capital asset exception for self-created property does not apply to non-individual creators, such as corporations whose employees or independent contractors created the copyrights. These distinctions lack any theoretical justification.

Current charitable deduction rules for intellectual property donations raise equity concerns in that they favor income-generating intellectual property over non-income-generating intellectual property. Further, they favor donors who give income-generating intellectual property to commercially-driven charities over donors who give similar property to non-commercially-driven charities. Consider two corporations planning to donate similar technologies with equal values. ABC Company makes a donation to a large university that will use the intellectual property in ways that will directly generate income. XYZ Company, however, makes its donation to small college that emphasizes education and basic research. Prior to 2004, the Code granted both companies an extent of the corporation’s capital gains).

77 I.R.C. § 167(g)(8)(A), as added by the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 207, 120 Stat. 350. This is a temporary provision; an election may not be made for any tax year beginning after December 31, 2010. The special five-year option applies to capitalized expenditures paid or incurred by music publishers, performers, producers, and recording companies who acquire any applicable musical property (as well as to capitalized expenditures paid or incurred by songwriters and composers who create any applicable musical property).

78 I.R.C. §§ 1221(a)(3) (excluding from capital asset definition self-created copyrighted works), 1231(b)(1)(C) (excluding from the definition of section 1231 property self-created copyrighted works).

initial tax deduction for the same amount—the fair market value of the donated property. As amended, the Code does not grant either company a fair market value deduction in the year of gift. The Code, however, does give ABC Company future charitable tax deductions equal to a certain percentage of the royalty income earned by its chosen donee, the commercially-driven university. Because the small college’s utilization of XYZ Company’s donated intellectual property will not directly generate income, XYZ receives no tax benefit for its charitable giving. Favoring intellectual property used in applied research (over that used for

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80 Since 1917, the government has provided a financial incentive for taxpayers to transfer property to charities by giving taxpayers an immediate tax deduction for their donations. See Revenue Act of 1917, Pub. L. No. 65-50, § 1201(s), 40 Stat. 300, 330 (1917) (allowing a charitable tax deduction for contributions by individuals); see also Revenue Act of 1935, Pub L. No. 74-407, § 102(o), 49 Stat. 1014, 1016 (allowing a charitable tax deduction for contributions by corporations). For the modern day statutory provision, see I.R.C. § 170.

Historically, the amount of the taxpayer’s charitable contribution deduction was the fair market value of the property contributed. See Rev. Rul. 58-260, 1958-1 C.B. 126 (“The fair market value of an undivided interest in a patent, which is contributed by the owner of the patent to an organization described in Section 170(c) . . . constitutes an allowable deduction as a charitable contribution, to the extent provided in Section 170, in the taxable year in which the property was contributed.”); see also H.R. Rep. No. 91-413, at 53 (1969), reprinted in 1969 U.S.C.C.A.N. 1645, 1699 (providing that taxpayer who contributed appreciated property to charity was allowed deduction for fair market value of property); Treas. Reg. § 1.170A-1(c) (“If a charitable contribution is made in property other than money, the amount of the contribution is fair market value of the property at the time of the contribution reduced as provided in section 170(e)(1) . . . .”). The government defined “fair market value” as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.” Treas. Reg. § 1.170A-1(c)(2). The government, however, never fully articulated or formalized a standard or approach for determining the fair market value of donated intellectual property.

81 In 2004, in a drastic and hasty move, Congress amended the charitable deduction provision by eliminating the fair market value standard for contributions of most all forms of intellectual property, reducing the initial amount a donor may deduct. See I.R.C. § 170(e)(1)(B)(iii), as added by American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418. The 2004 legislation limits the initial charitable deduction of any type of intellectual property to 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 developments costs are often deducted when incurred.

82 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. I.R.C. § 170(m)(3). Specifically, the donor can take a deduction for up to ten years for gifts of royalty producing intellectual property to public charities. The amount of the charitable deduction is a percentage of the royalty income earned by the donee. The percentage declines over time. I.R.C. § 170(m)(1), (7).
fundamental or purely scientific research), and favoring donors who give to donees that are endowed with the physical facilities, financial resources, and personnel capability to exploit intellectual property solely for direct financial results, clearly violates notions of fairness.83

Tax inequities in the current tax regime governing intellectual property encourage taxpayers to plan transactions that minimize taxes. 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.84 A taxpayer planning to donate income-generating intellectual property to a charity will receive larger tax deductions if he donates the property to a donee that can use the intellectual property in ways that will directly generate income as opposed to a non-commercially-driven donee.85 These decisions should be tax neutral. Under the present tax regime, they are not.

III. EXPLORING EFFICIENCY IN THE INTELLECTUAL PROPERTY TAX SYSTEM

In addition to being fair, an income tax system governing intellectual property should embrace the principle of efficiency.86 In tax theory, efficiency means various things in various contexts. A tax system can be evaluated in terms of the extent to which it promotes or hinders economic efficiency. A tax system is efficient when it promotes economic growth and inefficient when it stifles beneficial economic behavior. Although tax systems are explicitly used to affect taxpayer behavior, most believe that a tax system should avoid distorting private market decisions as much as possible, thereby minimizing efficiency costs of taxation. A tax system can also be judged in terms of administrative efficiency—namely, the extent to which it minimizes taxpayer compliance and government enforcement costs.


84 As previously noted, the treatment of contingent payments for patents acquired separately (current deduction) is more generous than the treatment of contingent payments for patents that are acquired with a trade or business (deferral and amortization over fifteen years). See supra notes 70-72 and accompanying text.

85 Charitable tax deductions (beginning with the donation year) equal a percentage of income generated by the donated intellectual property. See supra note 82.

86 See supra notes 17-28 and accompanying text.
A. Limits of Current Incentives for Technology Development

Few intellectual property tax provisions have the explicit goal of promoting economic growth and improving the competitiveness of U.S. businesses. A tax deduction (enacted in 1954)\(^{87}\) and a tax credit (enacted in 1981)\(^{88}\) are available for certain technology development costs. As designed, however, both tax incentives are circumscribed in ways that limit their effectiveness.

The section 174 deduction for research expenditures applies to those inventors who use or intend to use their research results in a trade or business.\(^{89}\) It arguably does not apply to an inventor who merely intends to license the results of her inventive activities for taxable income (although a few courts have found a trade or business of inventing and permitted deductions).\(^{90}\) This limitation fails to recognize that, in today's innovation marketplace, very few individual inventors, startup companies, and young research entities develop their innovations into end products or

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\(^{87}\) I.R.C. § 174. Section 174 was enacted primarily to encourage research activity and stimulate economic growth and technological development. See H.R. Rep. No. 83-1337, reprinted in 1954 U.S.C.C.A.N. 4017, 4053; 100 Cong. Rec. 3425 (1954) (statement of Chairman Reed: “This provision will greatly stimulate the search for new products and new inventions upon which the future economics and military strength of our Nation depends. It will be particularly valuable to small and growing businesses.”). See also Donald C. Alexander, Research and Experimental Expenditures Under the 1954 Code, 10 TAX L. REV. 549 (1954-1955) (noting a primary reason for enacting section 174 was to create an incentive for new products and inventions through federal subsidy of research and development startups); William Natbony, The Tax Incentives for Research and Development: An Analysis and a Proposal, 76 GEO. L.J. 347, 349 (1987) (explaining that Congress decided to provide taxpayers with the option of an immediate deduction in order to encourage new research and development); Richard L. Parker, The Innocent Civilians in the War Against NOL Trafficking: Section 382 and High-Tech Start-Up Companies, 9 VA. TAX REV. 625, 694 (1990) (“The deduction election under section 174(a) is intended to encourage research and development activities by allowing the cost of such activities to be used to offset the income earned in the business at the earliest possible date.”).

\(^{88}\) I.R.C. § 41. Section 41 was enacted to encourage firms to increase their research expenditures over time. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 221(a), 95 Stat. 172, 241 (1981) (codified as amended at I.R.C. § 41) (establishing original research credit as I.R.C. § 44F). The credit is incremental in that it is equal to a certain percentage of qualified research spending above a base amount, which can be thought of as a firm’s normal level of research and development investment.

\(^{89}\) See supra notes 43-46 and accompanying text.

\(^{90}\) See supra notes 47-50 and accompanying text.
services for commercial exploitation in trade or business, but rather intend to sell or license their innovations to larger companies looking to acquire innovations to supplement their own research or build promising intellectual property portfolios. To achieve optimal research outcomes, tax law should recognize and adequately incentivize efforts by individual inventors, startups, and the like, regardless of their motives (whether the licensing of research results or the use of results in a trade or business).

The 20 percent research credit under section 41 was designed to encourage additional private sector investment in research and development. But the credit formula severely limits the provision’s effectiveness. The credit applies only to qualified research expenditures in excess of a base amount that is a “fixed-base percentage” of the taxpayer’s average annual gross receipts for the four preceding tax years. For established firms, the fixed-base percentage is generally based on a ratio of the taxpayer’s qualified research expenses to its gross receipts for years 1984 to 1988, capped at 16%. For start-up firms, the fixed-base percentage is set at three percent during the firm’s first five tax years with spending on qualified research and gross receipts; thereafter, the percentage is gradually adjusted to reflect the firm’s actual experience, so that by its eleventh year the percentage equals the firm’s total qualified research expenses relative to its total receipts for the fifth through tenth tax years. In no event shall the base amount be less than 50 percent of the qualified research expenses for the credit year.

91 Studies have shown that the credit has led to increased research spending. See, e.g., CONGRESSIONAL BUDGET OFFICE, FEDERAL SUPPORT FOR RESEARCH AND DEVELOPMENT (June 2007); GENERAL ACCOUNTING OFFICE, THE RESEARCH TAX CREDIT HAS STIMULATED SOME ADDITIONAL RESEARCH SPENDING (September 1989).

92 I.R.C. § 41(a), (c)(1).


95 I.R.C. § 41(c)(2). For tax years ending after December 31, 2006, taxpayers may, at their election, compute the research credit under another method—the alternative simplified credit method. The alternative simplified credit method is an amount equal to 12 percent of the amount by which the qualified research expenses exceed 50 percent of the average qualified research expenses for the three preceding taxable years. I.R.C. § 41(c)(5)(A), as added by the Tax Relief and Health Care Act of 2006. For taxpayers with no qualified research expenses for the three preceding years, the amount of the alternative simplified credit is equal to 6 percent of the qualified research expenses for the current year. Id. § 41(c)(5)(B).
The section 41 credit, as structured, fails to achieve optimal technology results. First, the credit’s reformulation over the years has limited the types of research for which the credit is available. Indeed, not all expenditures that qualify for the research deduction under section 174 qualify for the research credit under section 41, due to the special requirements and exceptions. Second, the incremental nature of the credit means that many businesses cannot utilize any of the credit. This could be the case, for example, if a company’s gross sales grew faster than its qualified research spending. Calculating today’s credit based on research spending relative to receipts in the years 1984-1988 does not reflect realities of today’s economic and technological world, and could penalize a company that had high research spending levels during the 1984-1988 base period (unless the alternative formula provided a benefit). The incremental nature of the credit clearly places U.S. businesses at a competitive disadvantage, as compared to international firms who are entitled to greater tax incentives in their countries for research spending. Third, the temporary nature of the credit makes it difficult for firms to plan ahead for research activities. The credit has been extended more than a dozen times since its enactment in 1981, sometimes retroactively after expiration. Efforts to make the credit permanent have failed due to revenue concerns. So every credit renewal year, the

96 For example, under section 41(d), “qualified research” means research where substantially all of the activities constitute elements of a process of experimentation related to a qualified purpose. I.R.C. § 41(d)(1)(C). The “process of experimentation” requirement narrows the definition of the term “qualified research;” indeed, the requirements for a process of experimentation under section 41 continue to be more stringent than the requirements for research and development in the experimental or laboratory sense under section 174. Compare Treas. Reg. § 1.174-2(a)(1) with Treas. Reg. § 1.41-4(a)(5)(i) (providing that “a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer’s research activities”). See Treas. Reg. § 1.41-4(a)(5)(i); Preamble, 69 Fed. Reg. 22, 24 (stating “merely demonstrating that uncertainty has been eliminated . . . is insufficient to satisfy the process of experimentation requirement. A taxpayer bears the burden of demonstrating that its research activities additionally satisfy the process of experimentation requirement”).

97 See supra note 95 (describing the alternative simplified credit method).


99 A one-year extension of the credit, for example, was estimated to cost the government almost $9 billion over ten years. Joint Committee on Taxation, Estimated Revenue Effects of H.R. 6049 (May 2008), available at http://www.jct.gov/publications.html?Func=startdownload&id=1293.
government must balance its desire to maximize tax revenue without stifling beneficial research and development activity.

B. Limits of Current Incentives for Technology Transfers

Under the current system, tax incentives for research are limited to the innovation development market. A problem with this development-focused approach is that there has been a major shift in the innovation development market toward a segmentation model, whereby small companies and research universities serve as epicenters of ideas and complement and maximize the innovation of large and established firms with strong marketing and distribution forces. The desirable transfers of innovation between segments can be either supported or hindered by the income tax system. Favorable tax rules governing assignments to private market acquirers and donations to public charities could serve to encourage transfers to the right acquirers for further research, product development or licensing. This would support the business and technology realities of today’s innovation segmentation, and allow new ideas to develop at a faster pace and, as well as foster strong competition. The current tax system is not designed as such.

1. Private Market Transactions

With respect to private market transactions, the income tax system could be used to create incentives for transferors or transferees, or both.

Presently, few transferors are guaranteed preferential capital gain treatment on the assignment of their inventions. Section 1235 guarantees capital gain treatment only to individuals (original inventors) who assign all substantial rights to their inventions. Section 1235 does not apply to the more common start-up companies and small research entities whose employees conduct their research. These developers must apply general tax rules in determining the character of their gains, with the result that such gains are often characterized as ordinary income (especially if the firm has sold a number of inventions over the years).

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100 Section 1235 guarantees capital gains rates, as opposed to higher ordinary income tax rates, for any transfer of all substantial rights to a patent by certain holders to unrelated parties. I.R.C. § 1235(a). A “holder” for purposes of section 1235 is defined as “any individual whose efforts created such property.” I.R.C. § 1235(b)(1). Although corporations and partnerships may not be qualified holders, each member of a partnership who is an individual, however, may qualify as a holder as to his or her pro-rata share of a patent owned by the partnership. Treas. Reg. § 1.1235-2(d)(2).

101 I.R.C. §§ 1221(a)(1), 1231(b)(1)(A)-(B) (precluding inventory and inventory-
Under the current regime, *transferees* of high technology receive few breaks for their acquisition costs. Without exception, purchasers of technology are subject to the general asset-capitalization rule (i.e., they must capitalize all costs of acquiring technology).\(^{102}\) This, of course, raises the costs of products that have a high technology content. Although the government has never done so, it could consider departing from the asset capitalization principle and allowing limited expensing of innovation purchase costs. Since 1981, the government has permitted small business taxpayers to elect to deduct immediately the cost of purchasing certain tangible property (e.g., business machines and equipment, transportation equipment, and communications equipment) that would otherwise have to be capitalized.\(^{103}\) Expanding this expense allowance to certain innovation acquisition costs would represent a significant tax subsidy for innovation investment and achieve other important goals. Chiefly, it would lower the cost of capital for innovations used in an active trade or business, which would reduce the tax burden on innovation acquirers and stimulate business investment and the economy. Policymakers had these goals in mind when they enacted special expensing provisions for tangible property;\(^{104}\) such objectives are equally applicable with respect to intangible innovations.

Expanding the expense allowance for limited acquisition costs would also serve to eliminate high administrative costs and reduce the harm caused by current irrational tax depreciation rules. It has been argued that the capitalization of costs is warranted only if followed by

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\(^{102}\) I.R.C. § 263; Treas. Reg. § 1.263(a)-4(b)(1)(i), (c) (providing that a “taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction”).

\(^{103}\) I.R.C. § 179. The type of property to which the election applies is “section 179 property,” defined generally as tangible, depreciable, personal property—as opposed to real property—that is acquired for use in the active conduct of a trade or business. I.R.C. § 179(d)(1). As a result of the Jobs and Growth Tax Relief and Reconciliation Act of 2003, off-the-shelf computer software was added to the list of section 179 property.

rational depreciation rules. The current system is far from rational, supporting the argument that capitalization is not necessarily justified for all intellectual property acquisition costs. As the authors have argued elsewhere, any immediate incentive for acquisition costs, such as the expensing option discussed here, should be limited to any innovations acquired for future development or licensing, and not to innovations acquired for offensive use purposes, as the use of patent portfolios to threaten others through litigation actually hinders innovation instead of promoting it.

Because the government is not likely to provide expensing options for innovation acquisition costs, focus is better centered on creating rational tax depreciation rules for capitalized acquisition costs. A more efficient tax depreciation system could be designed that would incentivize desirable innovation acquisitions. When designing new \textit{ex ante} depreciation rules, a decision would have to be made about whether to establish a grouping system for innovations--the current approach for all tangible property and intangible property acquired with a business--or to establish an asset-by-asset system, which is the current approach for intangible property acquired separately. A grouping system would achieve a greater administrative efficiency than an asset-by-asset depreciation system for innovation acquisitions, and, if designed properly, could also support a strong acquisition market.

Under a grouping system, intellectual property could be grouped into classes with arbitrary recovery periods for each class. The grouping system for intellectual property would alleviate some of the problems caused by the current system’s asset-by-asset approach--namely the burden of having to determine the useful life of separately acquired intellectual property or by applying the income-forecast method.

\begin{footnotesize}
\begin{enumerate}
\item[105] See Ethan Yale, \textit{When are Capitalization Exceptions Justified?}, 57 TAX L. REV. 549, 557-64 (2004) (arguing that flawed depreciation schedules may justify departure from normative capitalization but only in limited cases; otherwise, expensing may be a preferable neutrality-enhancing policy choice).
\item[107] See I.R.C. § 168(b) (listing various depreciation methods according to type of property).
\end{enumerate}
\end{footnotesize}
In selecting an appropriate recovery period for various classes of intellectual property, the government could make an effort to achieve some correlation between the prescribed groupings and the actual economic useful lives of intellectual property. The correlation between tax depreciation and economic depreciation would not have to be exact. Indeed, the government could design a system that is "accelerated." Many of the recovery periods for intellectual property could be shorter for tax purposes than for economic purposes. This means that purchasers of intellectual property could recover their costs more quickly tax-wise than the economic reality would dictate.

It might be tempting to adhere to a fifteen-year recovery period—the recovery period under the current scheme for many intangible assets. Under the current system, the applicable recovery period depends on how the intellectual property was acquired. For many intangibles acquired in a business acquisition, the government selected a recovery period of fifteen years. For separately acquired intangibles, the government uses an asset-specific approach. Although fifteen years is short compared to the unlimited lives of trade secrets, trademarks and trade names, fifteen years is much longer than the useful lives of many acquired patents. The government selected the recovery period of fifteen years so that the new legislation would be approximately revenue neutral over the first five years.\(^{110}\) Although much can be said for a simplified, revenue neutral approach, the depreciation regime is not ideal from the standpoint of encouraging desirable innovation acquisitions.

The government should consider exempting from the current fifteen-year period patents, patent applications, software and other high technology intellectual property that is purchased in the acquisition of a trade or business. Such property is capable of reasonable valuation and has relatively short commercial life no matter how it has been acquired. If technology derived its value from its relationship to a product, service, or goodwill and reputation of a business like a trademark or trade names does, it might make sense to provide an arbitrary fifteen year recovery period to avoid messy valuation and intangible asset allocation problems. However, high technology acquired as part of the purchase of a company does not necessarily derive its value from the goodwill and reputation of

\(^{110}\) See Staff of J. Comm. On Taxation, 103d Cong., Technical Explanation of Tax Simplification Act of 1993 147 (Comm. Print 1993) (acknowledging that the asset's useful life may either fall short or exceed the amortization period, but nevertheless establishing such amortization period based on the goal of revenue neutrality over the subsequent five fiscal years).
the business with which it is associated. High technology can be freely sold, assigned, or transferred without associated goodwill or other business assets. Hence, the depreciation schedule for technology need not parallel the arbitrary fifteen year schedule application to all intangibles acquired in a business acquisition, such as trademarks and trade names, which lack inherent value.

In regard to technology (whether acquired separately or with a business), short recovery periods, such as three or five years would incentivize investment in innovation capital. Short recovery periods would also recognize the relatively risky nature of high technology compared to other intangible assets. Risk, such as retirement risk and revenue risk, "can have a significant impact on the optimal design of depreciation rules."\footnote{See Jeff Strnad, *Tax Depreciation and Risk*, 52 SMU L. REV. 547, 547-48 (1999) (noting that “retirement risk must be taken into account in designing an accelerated schedule that does not favor some assets over others”).} As some economists have argued, "depreciation schedules for relatively risky assets should be accelerated to compensate the owners of such assets for bearing a disproportionately large share of the capital price risk."\footnote{Yale, *supra* note 105, at 572 (citing Jeremy I. Bulow & Lawrence H. Summers, *The Taxation of Risky Assets*, 92 J. Pol. ECON. 20, 37-38 (1984)). See Roger H. Gordon & John Douglas Wilson, *Measuring the Efficiency Cost of Taxing Risky Capital Income*, 79 AM. ECON. REV. 427, 438 (1989).} It is often difficult to determine whether certain acquired technology will produce benefits and, if so, how long benefits will last. For example, if a purchaser acquires technology at an early stage when patent applications for the technology are pending, the purchaser cannot be certain about whether all of the patent applications will mature to patents. In addition, even after the purchaser receives the patents, there is always a fear that the patents may be invalidated subsequently by a third party.

The government has already provided an artificially low recovery period for separately acquired computer software. In 1993, Congress created an arbitrary three-year depreciation period for capitalized costs of separately acquired software (software that is not acquired as part of the purchase of a trade or business).\footnote{See supra note 65 and accompanying text.} This reduces the cost of, and encourages investment in, computer software, allowing U.S. firms to compete in the world market place. The government could expand the three-year recovery period for computer software to similar high technology intellectual property, such as advanced formulae, processes or
Short write-off periods such as those proposed here run counter to the basic principle underlying the justification for tax depreciation. The goal of tax depreciation is to measure the decline in the value of property due to wear, tear, and obsolescence, and to match the cost recovery of the property with the income stream produced by the property. This matching goal is difficult to achieve, however, and has given way in recent years in efforts to achieve tax simplification and in efforts to promote economic growth. In the 1980s, Congress created artificially low recovery periods for depreciable tangible property (3, 5, and 7 years in most cases); recent case law has permitted rapid write offs of antique tangible property used in trade or business, even though such property does not have a determinable useful life and usually increases in value. In 1993, Congress created a fifteen-year recovery period for many intangibles some of which have unlimited lives and were theretofore not considered eligible for depreciation allowances. These rules increase tax revenue loss for the government, but such losses are considered outweighed by the benefits—such as lower efficiency costs and the potential competitive advantages to be gained by U.S. businesses.

2. Public Charitable Transfers

In the current innovation development segmentation market, many universities and other not-for-profit organizations engage in valuable research activities. An efficient tax system should encourage transfers of undeveloped innovation to such charitable donees. Historically, the charitable tax deduction was a vital tool for the transfer of technology from research corporations to research universities and other nonprofit donees, wherein the technology could be exploited properly.

114 Statement of the Electronic Industries Association, at 160-161 (arguing a shorter recovery period is warranted for high technology intellectual property since such property is very similar to computer software).


116 See, e.g., Simon v. Comm’r, 68 F.3d 41 (2d Cir. 1995) (allowing tax depreciation for antique violin bows even though the taxpayers could not demonstrate that the bows had a determinable useful life).

117 For early arguments for and against depreciation deductions for trademarks and trade names, see Michael J. Dunne & Elizabeth A. Barba, The Tax Treatment of Trademarks Gets Renewed Attention in Congress, NAT’L L.J. S15, (col. 2).

118 Large corporations with research and development facilities often develop
As a result of 2004 legislation aimed at reducing the number of negligent and intentional over valuations of intellectual property donations, there is now very little immediate economic incentive for charitable giving of any type of intellectual property.\textsuperscript{119} Presently, few technology donors receive any immediate tax benefit for their contributions. Donors can take future deductions if the donated intellectual property generates income for the charitable donee. But providing donors with uncertain, declining, future economic incentives does not adequately encourage intellectual property donations. Even if a charitable donee licenses the donated intellectual property, the potential future deduction will not be substantial enough. It may take the charity several years before it receives any financial return on its donated intellectual property. Even if the intellectual property begins to generate royalty revenues, the amount of the future charitable deductions under the new law declines by use of a sliding-scale percentage (the percentage decreases each year). Indeed, in the tenth post-contribution year, the donor may deduct only 20\% of the income.

C. Administrative Inefficiencies Under Current IP Tax Regime

In addition to promoting economic efficiency, the general rule is that a good tax system should also be administratively efficient. Many of the special rules governing intellectual property were enacted to reduce uncertainty and complexity encountered when applying general tax rules to intellectual property transactions.\textsuperscript{120} Section 174 reduced uncertainties over the application of the asset-capitalization rule to research and development expenditures.\textsuperscript{121} Section 1235 reduced uncertainties over the application of the asset-capitalization rule to research and development expenditures.\textsuperscript{121} Section 1235 reduced uncertainties over the

\textsuperscript{119} See supra notes 80-83 and accompanying text.

\textsuperscript{120} See generally Nguyen & Maine, supra note 6 (analyzing the development of special tax rules governing intellectual property assets).

\textsuperscript{121} While a primary justification for section 174 was to encourage new research and development activity and stimulate economic growth and technological development, another justification was to reduce uncertainties caused by applying the asset-capitalization rules to research and development activities. See David S. Hudson, The Tax Concept of Research or Experimentation, 45 TAX LAW. 85, 88-89 (1991) (explaining that
tax treatment of patent transfers, and section 1253 alleviated uncertainties and much litigation over the tax treatment of trademark and trade name transfers. Section 197 was enacted “to simplify the rules for another justification for section 174 is that the capitalization rule is difficult to applying to research and development costs; George Mundstock, Taxation of Business Intangible Capital, 135 U. Pa. L. Rev. 1179, 1258-59 (1987) (stating a reason for enacting section 174 was to reduce uncertainty caused by applying the asset-capitalization rules to research and development).

While section 1235 was intended to encourage research and development that potentially leads to patentable inventions, it was also an attempt to reduce uncertainty and minimize disputes over the application of general tax principles to patent transfers. For example, when applicable, section 1235 provides statutory assurance that a patent transfer will not be deemed a license merely because of the existence of contingent payments. See I.R.C. § 1235(a) (providing that section 1235 applies regardless of whether the payments received are payable periodically over a period generally coterminous with the transferee's use of the patent or are contingent on the productivity, use, or disposition of the property transferred); see also S. Rep. No. 83-1622, at 439 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 5082 (stating that section 1235 was intended “to give statutory assurance to certain patent holders that the sale of a patent (whether as an 'assignment' or 'exclusive license') shall not be deemed not to constitute a 'sale or exchange' for tax purposes solely on account of the mode of payment”).

Section 1235 also eliminates uncertainties over whether a patent transferor is an amateur (who is eligible for capital gain treatment under general tax principles) or a professional inventor (who is not eligible for capital gain treatment under general tax principles). See H.R. Rep. No. 83-1337, at A280 (1954); S. Rep. No. 83-1622 at 113 (1954), as reprinted in 1954 U.S.C.C.A.N. 4621, 4747 (stating that section 1235 can provide capital gains treatment to all inventors, whether amateur or professional, regardless how often they sell their patents).

And, section 1235 eliminates the need to ascertain the holding period of an invention for purposes of meeting the requisite one-year holding period under the general capital gain provisions. I.R.C. § 1222(3) (defining long-term capital gain as gain from the sale or exchange of a capital asset held for more than one year).

If the requirements of section 1235 are met (i.e., there exists a transfer of “all substantial rights” by a “holder” to an “unrelated party,” as those terms are defined for purposes of section 1235), then a patent transferor is assured capital gain treatment. Determinations of what constitutes a “sale” or a “capital asset” under general sale or exchange principles.


Section 1253 mandates ordinary income treatment on all payments that are contingent on the productivity, use, or disposition of a trademark or trade name. I.R.C. § 1253(c). Section 1253 imposes ordinary income treatment on non-contingent payments.
depreciating intangibles and to reduce the number of controversies arising from the need to determine which intangibles are depreciable and what their recovery periods should be.\footnote{124 Mary LaFrance, \textit{Days of our Lives: The Impact of Section 197 on Copyrights, Patents and Related Property}, 24 HOFSTRA L. REV. 317, 320 (1995).}

The problem is that few of the special tax rules are conclusive. Their limitations and exceptions mean the tax outcome for many intellectual property assets and transactions is determined under the general tax rules that were the source of initial complexity. For example, if section 174 does not apply, then a taxpayer must capitalize the research costs. However, complex questions arise in applying the asset-capitalization principle to research costs: When do research activities result in an identifiable asset? How does one apportion the costs if a particular project partly succeeds and partly fails or if different and simultaneous research activities contribute in varying degrees to the development of an asset or more than one asset?

If section 1235 does not apply to the assignment of a patent, then general sale or exchange principle must be applied in determining the tax treatment of a particular transfer. But difficult-to-answer questions with respect to technology, questions that justified adoption of the special rule, must be addressed: Does the transfer constitute a sale? Is the subject of transfer a capital asset? What is the holding period?

If section 197 does not apply to an intellectual property acquisition, then tax depreciation allowances are determined under the asset-specific approach that applied before enactment of the special provision—such assets are depreciated under the straight-line or income-forecast method. This approach sets up unnecessary rule, compliance, and transactional complexity, begging the question: Why have different (whether up-front or installment payments) received for the transfer of a trademark or trade name if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the mark or name. I.R.C. § 1253(a). The Code sets forth six potentially significant powers, any one of which, if retained, would require ordinary income treatment. I.R.C. § 1253(b)(2)(A)-(F). This list of retained powers is not exhaustive; rather, consideration is given to all the facts and circumstances existing at the time of a transfer to determine whether an unenumerated power constitutes a significant power. For example, the duration of the relevant restriction is important in determining whether the restriction is significant. See Stokely USA, Inc. v. Comm’r, 100 T.C. 439 (1993) (finding insignificant a five-year right to disapprove a transfer as significant, but finding significant a twenty-year restriction preventing the transferee from using the trademark on certain products).

depreciation methods and different write-off periods for the same type of technology depending solely upon the method of technology transfer?\textsuperscript{125}

Although designed to enhance administrative efficiency, in reality the new charitable deduction rules applicable to technology contributions are quite inefficient. The new law’s focus on future tax deductions imposes heavy administrative burdens, including modified and expanded record-keeping requirements, on both intellectual property donors and charitable donees. Because the new law allows donors to take deductions over a period of years determined on the income derived from the donated property, the donor and the donee organization must communicate with one another and the IRS for several years following a qualified contribution.\textsuperscript{126} By allowing future deductions to be based on income received or accrued by the charity from the donated property itself, rather than from income stemming from the activity in which the donated property is used, the new law places a difficult burden on charities to track their specific intellectual property assets. Moreover, in regard to considering future tax deductions at stake under the new law, donors will incur substantial monitory costs.

III. DEVELOPING A LEGAL FRAMEWORK FOR INTELLECTUAL PROPERTY TAXATION

Using the norms of equity and efficiency to evaluate the current intellectual property tax regime highlights fundamental flaws with the regime. The defective nature of the present system can be attributed to the lack of an appropriate legal framework for intellectual property tax legislation. The current regime evolved over time as particular concerns arose. But at no time was a framework of rational intellectual property and tax policy objectives used in developing rules to ensure a sound system. The following questions illustrate some important considerations that could help shape an appropriate framework for tax legislation governing intellectual property. To what extent, if any, should tax rules be in harmony with intellectual property goals? To what extent, if any, should the tax system adopt distinctions among intellectual property rights? If tax distinctions are adopted, what is a rational basis for making coherent tax distinctions? To what extent, if any, should the tax system’s treatment of intangible intellectual property be reconciled with its treatment of tangible property.

\textsuperscript{125} Statement by Benac, at 52.

A. Establishing Harmonization with Intellectual Property Goals and Incentives

Inefficiencies in the current tax regime governing intellectual property may or may not be justified depending on one’s view of whether or not the tax system should support the intellectual property system. The Code contains a few special tax provisions designed to encourage and reward development of certain types of intellectual property.\textsuperscript{127} However, these tax rules are circumscribed in ways that limit their effectiveness.\textsuperscript{128} In addition, they apply only to the development of patents and patent-like property, and do not apply to the creation of other types of intellectual property, such as copyrights and trademarks. This system might be deemed efficient if one adopts a narrow view of what social and economic benefits are derived from intellectual property.\textsuperscript{129} This tax scheme might be deemed inefficient, however, if one accepts a broader view of intellectual property’s positive effects on society. An appropriate legal framework for intellectual property tax rules would consider the extent to which harmonization should be achieved between the intellectual property and taxation schemes. Specifically, should the tax system promote or inhibit the intellectual property system?

Few people would disagree that encouraging and rewarding inventions and works of authorship is critical to U.S. economic growth. When the Founding Fathers included the Patent and Copyright Clause in Section 8, Article I of the Constitution, their words clearly conveyed the objective of rewarding inventors exclusive rights in their inventions.\textsuperscript{130}

\textsuperscript{127} I.R.C. §§ 41 (credit for limited research expenditures), 174 (current deduction for limited research expenditures), 1235 (capital gains treatment on limited assignments of innovation).

\textsuperscript{128} See supra notes 87-101 and accompanying text.

\textsuperscript{129} It might be deemed efficient if one accepts a meaning of tax efficiency other than the one used here. Indeed, some might argue that the “efficiency criterion requires that a tax interfere as little as possible with people’s economic behavior.” Graetz & Schenk, supra note 7, at 29 (providing several different meanings of tax efficiency). See supra notes 17-23 and accompanying text.

\textsuperscript{130} U.S. Const. art. I, § 8, cl. 8. See Seymour v. Osborne, 11 Wall. 516, 533-534 (1871) (“Letters patent are not to be regarded as monopolies ... but as public franchises granted to the inventors of new and useful improvements for the purpose of securing to them, as such inventors, for the limited term therein mentioned, the exclusive right and liberty to make and use and vend to others to be used their own inventions, as tending to promote the progress of science and the useful arts, and as matter of compensation to the inventors for their labor, toil, and expense in making the inventions,
The Founding Fathers believed that such a reward-based system would “promote the Progress of Science.” Conversely, they also understood that unfettered rights would not advance the progress of science, and therefore placed a time limit on the exclusivity for patents. As Thomas Jefferson’s writings demonstrate, patent grants should only be issued by the government to truly warranted inventions. The patent statute and subsequent amendments require that an invention be novel and nonobvious, among other statutory patentability factors, in order for the invention to be granted a patent. In other words, patent grants are for innovation.

131 U.S. CONST. art. I, § 8, cl. 8. See Pfaff v. Wells Electronics, Inc., 525 U.S. 55, 63 (1998) (“The balance between the interest in motivating innovation and enlightenment by rewarding invention with patent protection on the one hand, and the interest in avoiding monopolies that unnecessarily stifle competition on the other, has been a feature of the federal patent laws since their inception.”).

132 See generally Bonito Boats, Inc. v. Thunder Craft Boats, Inc., 489 U.S. 141, 146 (1989) (“The Patent Clause itself reflects a balance between the need to encourage innovation and the avoidance of monopolies which stifle competition without any concomitant advance in the ‘Progress of Science and useful Arts.’”); Sears, Roebuck & Co. v. Stiffel Co., 376 U.S. 225, 229 (1964) (“Patents are not given as favors . . . but are meant to encourage invention by rewarding the inventor with the right, limited to a term of years fixed by the patent, to exclude others from the use of his invention.”).

133 See generally Graham v. John Deere Co. of Kansas City, 383 U.S. 1, 9 (1966) (reviewing Thomas Jefferson’s writings and his influences on shaping the patent system and concluding that “Jefferson did not believe in granting patents for small details, obvious improvements, or frivolous devices. His writings evidence his insistence upon a high level of patentability.”). See also Bonito Boats, 489 U.S. at 147 (noting that “[t]oday's patent statute is remarkably similar to the law as known to Jefferson in 1793. Protection is offered to whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof.”) (internal citations omitted).

134 See KSR Intern. Co. v. Teleflex Inc., 550 U.S. 398 (2007) (recognizing that “[g]ranting patent protection to advances that would occur in the ordinary course without real innovation retards progress and may, for patents combining previously known elements, deprive prior inventions of their value or utility”).

135 See generally Bonito Boats, 489 U.S. at 146 (“From their inception, the federal patent laws have embodied a careful balance between the need to promote innovation and the recognition that imitation and refinement through imitation are both necessary to invention itself and the very lifeblood of a competitive economy.”); Qualitex Co. v. Jacobson Products Co., Inc., 514 U.S. 159, 164 (1995) (“It is the province of patent law, not trademark law, to encourage invention by granting inventors a monopoly over new product designs or functions for a limited time, 35 U.S.C. §§ 154,
The goals behind trade secret law are to encourage innovation and promote responsible business conduct.\textsuperscript{136} Trade secrets are treated as property, and courts have held that regulations forcing disclosure of a trade secret amount to the taking of property by the government, and that the trade secret owner must be accordingly compensated.\textsuperscript{137} Unauthorized use of trade secrets or the non-governmental taking or disclosing of trade secrets are prohibited by law; most states have statutes on the misappropriation of trade secrets.\textsuperscript{138}

\textsuperscript{136} The Supreme Court has long recognized that with respect to innovations not eligible for patent protection, “[t]rade secret law will encourage invention in areas where patent law does not reach, and will prompt the independent innovator to proceed with the discovery and exploitation of his invention. Competition is fostered and the public is not deprived of the use of valuable, if not quite patentable, invention.” Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 485 (1974) (“The maintenance of standards of commercial ethics and the encouragement of invention are the broadly stated policies behind trade secret law.”). The Kewanee Oil Court also stated that the Pennsylvania Supreme Court had noted in Wexler v. Greenberg, 160 A.2d 430, 434-35 (P.A. 1960), “the importance of trade secret protection to the subsidization of research and development and to increased economic efficiency within large companies through the dispersion of responsibilities for creative developments.” \textit{Id.} at 482. See also \textit{Restatement (Third) of Unfair Competition} § 39 cmt.a (“[T]he protection of trade secrets has been justified as a means to encourage investment in research by providing an opportunity to capture returns from successful innovations.”). Not surprisingly, commentators have had their disagreements on the justifications of trade secret protections. See, e.g., Mark Lemley, \textit{The Surprising Virtues of Treating Trade Secrets as IP Rights}, 61 STAN. L. REV. 311, 314 (2008) (stating that trade secrets promote innovations and reduce business misconduct). Michael Abramowicz & John F. Duffy, \textit{Intellectual Property for Market Experimentation}, 83 N.Y.U. L. REV. 337, 391 (2008) (asserting that “the goal of trade secret law is not to encourage the production of . . . information so much as the production of . . . business”); Michael Risch, \textit{Why Do We Have Trade Secrets?}, 11 MARQ. INTELL. PROP. L. REV. 1, 26-27 (2007) (arguing that “creating incentives to innovate is a very minor justification of trade secret law”)

\textsuperscript{137} See, e.g., Ruckelshaus v. Monsanto, 467 U.S. 986, 1002-04 (1984); Philip Morris, Inc. v. Reilly, 312 F.3d 24 (1st Cir. 2002) (en banc) (holding that state regulation requiring disclosure of the content of cigarettes was a taking of trade secrets). See also E. I. du Pont de Nemours & Co. v. United States, 288 F.2d 904, 912 (Ct. Cl. 1961) (upholding takings claim); DVD Copy Control Ass'n v. Bunner, 75 P.3d 1, 14 (Cal. 2003) (holding that trade secrets represent “a constitutionally recognized property interest in [information]”); 1 \textit{Roger M. Milgrim & Eric E. Bensen, Milgrim on Trade Secrets} § 2.01 [1]-[2], 2-23 (2008) (stating that “[p]ractically all jurisdictions have recognized that a trade secret is property” at least in certain senses).

The current tax regime governing intellectual property was designed, although not optimally, to promote the innovation goals of patents and patent-like property. The touching point, however, is the extent to which U.S. laws should promote other intellectual property activities. It could be argued that the current tax regime does not adequately promote the goals of other types of intellectual property, such as copyrights and trademarks, but actually hinders them. Ironically, most if not all intellectual property rights (not just patents) achieve similar goals: innovation and/or efficiency policy objectives. Both patent and copyright laws in general, and to a smaller extent trade secret laws, focus on innovation. Trademark laws center on the facilitation of efficiency in the marketplace for the producer of trademarked products or services and the consumer.

With respect to copyrights, the Patent and Copyright Clause in Section 8, Article I of the Constitution conveys the Founding Fathers’ clear intention to reward authors exclusive rights to their works under the belief that a reward-based system would “promote the Progress of Science and the Useful Arts.” The Founding Fathers understood that unfettered rights would not advance the progress of useful arts, and therefore placed a time limit on the exclusivity for copyrights, the same as they did for patents. Copyright law requires that a work of authorship be original, and fixed in a tangible medium of expression. Works of authorship under copyright law cover a wide range of subject matters; movies, video games, software, music and books are among works of authorship. Originality means the works must be created independently by the author and the works must bear some creativity. Copyrights include the

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139 U.S. Const. art. I, § 8, cl. 8.

140 Id.

141 17 U.S.C. § 102(a) (“Copyright protection subsists . . . in original works of authorship fixed in any tangible medium of expression . . . from which they can be perceived, reproduced, or otherwise communicated.”).

142 17 U.S.C. § 102(a) provides a list of categories for works of authorship: (1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sound recordings; and (8) architectural works.

143 See Feist Publications, Inc. v. Rural Telephone Service Co., Inc., 499 U.S. 340, 358-59 (1991) (stating that “[o]riginality requires only that the author make the selection or arrangement independently, and that it display some minimal level of creativity. Presumably, the vast majority of compilations will pass this test, but not all
exclusive rights to make copies, prepare derivative works, distribute the works, display the works in public, and perform the works in public.\textsuperscript{144} The bundle of rights does not last forever, as it faces a time limit.\textsuperscript{145}

As with patents, the exclusive rights in copyrights, though limited in time, are granted to encourage the progress of science and the useful arts for the benefit of society.\textsuperscript{146} There is a long-held belief that copyright protection promotes innovation and the “creative activity of authors,”\textsuperscript{147} and induces authors and artists to “release to the public the products of his creative genius.”\textsuperscript{148} Technological advances in the reproduction and will. There remains a narrow category of works in which the creative spark is utterly lacking or so trivial as to be virtually nonexistent.

\textsuperscript{144} See New York Times Co., Inc. v. Tasini, 533 U.S. 483, 495 n.4 (2001). See also 17 U.S.C. § 106 (“Subject to sections 107 through 121, the owner of copyright under this title has the exclusive rights to do and to authorize any of the following: “(1) to reproduce the copyrighted work in copies or phonorecords; (2) to prepare derivative works based upon the copyrighted work; (3) to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending; (4) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly; (5) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work, to display the copyrighted work publicly; and (6) in the case of sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission.”.


\textsuperscript{146} See generally Mazer v. Stein, 347 U.S. 201, 219 (1954) (“The economic philosophy behind the clause empowering Congress to grant patents and copyrights is the conviction that encouragement of individual effort by personal gain is the best way to advance public welfare through the talents of authors and inventors in ‘Science and useful Arts.’”); United States v. Paramount Pictures, 334 U.S. 131, 158 (1948) (“The copyright law, like the patent statutes, makes reward to the owner a secondary consideration. . . . It is said that reward to the author or artist serves to induce release to the public of the products of his creative genius.”).

\textsuperscript{147} Sony Corp. v. Universal City Studios, 464 U.S. 417, 429 (1984) (explaining that copyright's monopoly privileges “are neither unlimited nor primarily designed to provide a special private benefit. Rather, the limited grant is a means by which an important public purpose may be achieved. It is intended to motivate the creative activity of authors and inventors by the provision of a special reward.”). But see Stewart E. Sterk, \textit{Rhetoric and Reality in Copyright Law}, 94 Mich. L. Rev. 1197, 1205, 1209, 1213-15 (1996).

\textsuperscript{148} See Paramount Pictures, 334 U.S. at 158. See also Stephen Breyer, \textit{The Uneasy Case for Copyright: A Study of Copyright in Books, Photocopies, and Computer Programs}, 84 Harv. L. Rev. 281, 288-89 (1970) (examining the “property” right in
distribution of copyrighted works, however, force new changes in copyright law, as Congress continually searches for a balance between copyright protection and future innovations. In summary, the U.S. Constitution empowers Congress to promote the progress of both science and the useful arts, and as a consequence, Congress has granted significant protections for both patents and copyrights with “all that means for the social and economic benefits.” The intellectual property system encourages innovation by rewarding both inventors and authors exclusive rights in their inventions and works of authorship for a limited time. Patentees and copyright owners can

149 See Eldred, 537 U.S. at 222 (“[T]he Copyright Clause empowers Congress to determine the intellectual property regimes that, overall, in that body's judgment, will serve the ends of the Clause. . . . Congress may implement the stated purpose of the Framers by selecting the policy which in its judgment best effectuates the constitutional aim.”).

150 Sony Corp. of Am. v. Universal City Studios, Inc., 464 U.S. 417, 430 (1984) (“From its beginning, the law of copyright has developed in response to significant changes in technology. Indeed, it was the invention of a new form of copying equipment-the printing press--that gave rise to the original need for copyright protection.”) (footnote omitted); H.R. Rep. No. 104-554, at 6 (1996) (“The Copyright Act was last generally revised in 1976, in response to the many technological changes that had occurred since the enactment of the 1909 Act. Since 1976, Congress regularly has had to address new issues, especially those raised by new technologies or new methods of exploitation.”); H.R. Rep. No. 101-735, at 7 (1990) (“Even though the 1976 Copyright Act was carefully drafted to be flexible enough to be applied to future innovations, technology has a habit of outstripping even the most flexible statutes. Copyright is, in large part, a response to new technology.”); Douglas Reid Weimer, Digital Audio Recording Technology: Challenges to American Copyright Law, 22 ST. MARY'S L.J. 455, 491 (1990) (“Over the years, American copyright law has evolved in order to respond to societal and technological changes.”).

151 Diamond v. Chakrabarty, 447 U.S. 303, 315 (1980) (“The subject-matter provisions of the patent law have been cast in broad terms to fulfill the constitutional and statutory goal of promoting “the Progress of Science and the useful Arts” with all that means for the social and economic benefits envisioned by Jefferson.”).

152 Shaw v. Cooper, 32 U.S. 292, 320 (1833) (“The patent law was designed for the public benefit, as well as for the benefit of inventors. For a valuable invention, the public, on the inventor's complying with certain conditions, give him, for a limited period, the profits arising from the sale of the thing invented. This holds out an inducement for the exercise of genius and skill, in making discoveries which may be useful to society, and profitable to the discoverer.”). See generally Bonito Boats, Inc. v. Thunder Craft Boats, Inc., 489 U.S. 141, 146 (1989); Sears, Roebuck & Co. v. Stiffel Co., 376 U.S. 225, 229 (1964).
exploit their intellectual property rights for economic gain. The public benefits greatly from the innovations, as more inventors and authors create more programs and technologies that transform every industry, from biotechnology to communications and entertainment. Furthermore, even after a patent or copyright expires, the patent or copyright becomes part of the public domain and the public is free to use the knowledge embodied in the expired patent or to freely copy and distribute the works. The Supreme Court in *Kewanee Oil v. Bicron* in a case involving patents and trade secrets, keenly observed that the intellectual property system produces a “positive effect on society through the introduction of new products and processes of manufacture into the economy, and the emanations by way of increased employment and better lives for our citizens.”

Although substantive copyright laws serve to induce creative genius and the release to the public of the products of that genius, the current tax system does not. A tax credit is not available for copyright creation expenditures, but does exist for patent development costs. Tax deduction rules do not adequately incentivize creation activities, requiring as a general rule the capitalization of copyright creation costs. Moreover, tax rules governing copyright assignments are quite harsh. Indeed, since 1950 Congress has prevented copyright creators from

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154 Mazer v. Stein, 347 U.S. 201, 219 (1954) (“The economic philosophy behind the clause empowering Congress to grant patents and copyrights is the conviction that encouragement of individual effort by personal gain is the best way to advance public welfare through the talents of authors and inventors in ‘Science and useful Arts.’”).

155 Twentieth Century Music Corp. v. Aiken, 422 U.S. 151,156 (1975) (“The immediate effect of our copyright law is to secure a fair return for an 'author's' creative labor. But the ultimate aim is, by this incentive, to stimulate [the creation of useful works] for the general public good.”).

156 Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 480 (1974) (“The patent laws promote this progress by offering a right of exclusion for a limited period as an incentive to inventors to risk the often enormous costs in terms of time, research, and development. The productive effort thereby fostered will have a positive effect on society through the introduction of new products and processes of manufacture into the economy, and the emanations by way of increased employment and better lives for our citizens.”).

157 See supra note 37 and accompany text.
receiving capital gains treatment upon the sales of their copyrights.158 Conversely, patent developers were not covered by the 1950 legislation, and to this day may be eligible for capital gains treatment upon the sale of their patents. Finally, since 1969 charitable tax deduction rules have provided no incentive for donations of self-created copyrights to public charities. In that year, Congress reduced the amount of the tax deduction from fair market value to the creator’s adjusted basis in the copyright, which is typically very low.159 At the same time, the law did not impact patent donors who were entitled to deduct the fair market value of their donated patents.160 An appropriate legal framework for intellectual property taxation would consider harmonization between the copyright system and the tax system.

In contrast to copyright laws, trademark laws do not exist to reward trademark owners for innovations of products or services.161 Rather, trademark laws are recognized as important to facilitate efficiency.162 Specifically, trademark laws prevent competitors from copying source-identifying marks and minimizing the likelihood of consumer confusion.163 Consumers can rely on the trademarks in their

158 Revenue Act of 1950, ch. 994, § 210, 64 Stat. 906, 933 (codified as amended in I.R.C. § 1221(a)(3)).


160 This law changed in 2004, when Congress amended the charitable deduction provision by eliminating the fair market value standard for contributions of most all forms of intellectual property, and reducing the initial amount a donor may deduct. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified as amended in I.R.C. § 170(e)(1)(B)(iii)).

161 See TrafFix Devices, Inc. v. Marketing Displays, Inc., 532 U.S. 23, 29, (2001). “The Lanham Act does not exist to reward manufacturers for their innovation in creating a particular device; that is the purpose of the patent law and its period of exclusivity.” Id., at 34. Federal trademark law “has no necessary relation to invention or discovery.” In re Trade-Mark Cases, 100 U.S. 82, 94 (1879).

162 See International Bancorp, LLC v. Societe des Bains de Mer et du Cercle Des Etrangers a Monaco, 329 F.3d 359, 381 (4th Cir. 2003) (stating that “the very real interest that our trademark laws have in minimizing consumer confusion” is to ensure “that our economy may enjoy the greatest possible of efficiencies”). William M. Landes & Richard A. Posner, The Economics of Trademark Law, 78 TRADEMARK REP. 267 (1988) (“The overall conclusion is that trademark law . . . can best be explained on the hypothesis that the law is trying to promote economic efficiency”).

163 See Berner Intern. Corp. v. Mars Sales Co.,987 F.2d 975 (3rd Cir. 1993) (commenting that “[t]rademark protection is desirable because of the efficiencies and incentives produced by symbolic affiliation of producer and quality product”).
decision on whether or not to purchase a product or service. Consequently, trademark laws reduce the consumers’ costs of shopping and making purchasing decisions and help to assure “a producer that it (and not an imitating competitor) will reap the financial, reputation-related rewards associated with a desirable product”

Current tax rules governing trademarks and trade names were not designed with these efficiency goals in mind. Capitalized trademark and trade name costs were not depreciable or amortizable at all prior to 1956 or between 1986 and 1993. During these periods, they could only be recovered upon abandonment or sale of the mark or name, reflecting a government belief that there was no basis for a presumption that investment in trademark and trade names produce social benefits that market forces might adequately reflect. The capitalized costs of patents, however, have always been eligible for depreciation allowances. As


165 Qualitex Co. v. Jacobson Products Co., 514 U.S. 159, 163-164 (1995). As explained by the Court in Qualitex:
In principle, trademark law, by preventing others from copying a source-identifying mark, “reduce[s] the customer’s costs of shopping and making purchasing decisions,” for it quickly and easily assures a potential customer that this item—the item with this mark—is made by the same producer as other similarly marked items that he or she liked (or disliked) in the past. At the same time, the law helps assure a producer that it (and not an imitating competitor) will reap the financial, reputation-related rewards associated with a desirable product. The law thereby encourages the production of quality products, and simultaneously discourages those who hope to sell inferior products by capitalizing on a consumer’s inability quickly to evaluate the quality of an item offered for sale.” (Internal quotations omitted).

Id. See also Mark Bartholome, Advertising and the Transformation of Trademark Law, 38 N.M. L. REV. 1, 1 (2008) (stating that trademark law promotes efficiency as consumers reduce their research cost by relying on brand names); Mark P. McKenna, The Normative Foundations of Trademark Law, 82 NOTRE DAME L. REV. 1839, 1841-43, 1848 (2007) (critiquing the law and economic approach to trademark law which emphasizes on economic efficiency of trademark law purposes).


167 An early Treasury regulation provided that if an acquired intangible asset could be shown to have a limited useful life, then the capitalized acquisition costs were recoverable over that asset’s useful lifetime. Treas. Reg. § 1.167(a)-3. Under this rule,
another example, Congress enacted a special provision in 1969 mandating ordinary income treatment on contingent payments received in a trademark or trade name transfer, regardless of whether the transfer is in substance a sale or a license.\(^{168}\) For patent transfers, in contrast, the nature of the payments (contingent or non-contingent) is irrelevant in determining tax consequences.\(^{169}\)

An appropriate legal framework for tax legislation governing intellectual property rights should consider the extent to which the tax system is harmonious with the intellectual property goals identified above. It is conceded that maintaining harmony with intellectual property goals can be challenging in a rapidly changing technology and business environment. For instance, special tax incentives for innovative developments were enacted more than fifty years ago.\(^{170}\) Since then, there has been a major shift in the innovation market towards a segmentation model. Desirable transfers of innovation between both segments can be either supported or hindered by the income tax system. An appropriate framework might consider the commercial and business realities of innovation segmentation, and suggest that tax incentives should not be limited to the innovation development market alone in order to encourage greater research activity and support economic growth. The result might be more favorable tax rules governing assignments to private market acquirers and governing donations to research universities that achieve optimal innovation outcomes and enhance economic growth.

\(^{168}\) I.R.C. § 1253(c).

\(^{169}\) Early on, the government and courts struggled with the issue of whether a patent assignment should be denied capital gains treatment solely because the purchase price took the form of contingent payments. Early cases were split on the issue. Some courts held that the receipt of contingent payments did not prevent a transfer from being considered a sale. See, e.g., Comm’r v. Hopkinson, 126 F.2d 406 (2d Cir. 1942); Comm’r v. Celanese Corp., 140 F.2d 339 (D.C. Cir. 1944). Others held the receipt of contingent payments did preclude sale treatment. See, e.g., Bloch v. United States, 200 F.2d 63 (2d Cir. 1952). In 1958, the Service issued an administrative pronouncement, ruling that patent transferors could enjoy “sale” treatment (and, hence, capital gain treatment) even though consideration received is measured by production, use, or sale of the patented article. Rev. Rul. 58-353, 1958-2 C.B. 408.

\(^{170}\) Sections 174 (deduction for limited research and experimental expenditures) and 1235 (safe harbor providing capital gains treatment for limited assignments of patents) were enacted in 1954, while section 41 (tax credit for limited research expenditures) was enacted much later in 1981.
Another recent phenomenon has been the change in the use of patents in business strategy—namely, the acquisition of patents for licensing purposes, or offensive-use purposes, as opposed to manufacturing purposes. An appropriate framework would consider the extent to which the tax system should support or hinder the paradigm shift in patent acquisitions. The current tax system treats all innovation acquisitions alike. However, to further the progress of science and other early goals, it might be determined that the licensing model should be supported, but that the offensive use model should not. Acquisition of patent portfolios for offensive use purposes to threaten others through litigation hinders innovation instead of generating it. Accordingly, it might be concluded that the offensive use of patents should not be supported by the tax system.171

B. Establishing a Rational Basis for Coherent Tax Distinctions

Inequities in the current tax system governing intellectual property can be attributed largely to tax distinctions made based on intellectual property law distinctions. In most cases, special tax rules governing intellectual property adopt an asset-specific approach, applying to one or more specific types of intellectual property, specifically defined for tax purposes. For example, section 1235 of the Code applies only to transfers of “patents” as specifically defined for tax purposes;172 section 1221(b)(3) applies only to transfers of copyrights in musical works;173 and section 1253 applies to transfers of “trademarks” and “trade names,” each of which is specifically defined for tax purposes.174

171 See supra note 106 and accompanying text.

172 I.R.C. § 1235(a) (guaranteeing capital gains treatment for any transfer of all substantial rights to a patent by a statutorily defined holder to an unrelated party); Treas. Reg. § 1.1235-2(a) (providing definition of patent for purposes of section 1235).

173 I.R.C. § 1221(b)(3) (providing that, at the election of a taxpayer, the section 1221(a)(1) and (a)(3) exclusions from capital asset status do not apply to musical compositions or copyrights in musical works sold or exchanged by a taxpayer described in section 1221(a)(3)).

174 I.R.C. § 1253(a) (requiring ordinary income treatment on all payments that are contingent on the productivity, use, or disposition of a trademark or trade name, and requiring ordinary income treatment on non-contingent payments received for the transfer of a trademark or trade name if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the mark or name). The terms trademark and trade name were broadly defined in regulations that were proposed in 1971, but eventually withdrawn due to a sunset provision. Prop. Treas. Reg. §§ 1.1253-1 to -3, 36 Fed. Reg. 13148 (July 15, 1971), withdrawn by 58 Fed. Reg. 25587 (Apr. 27,
There are a few tax provisions which make no tax distinctions among the different types of intellectual property. These provisions adopt a “grouping approach” and attempt to affect a larger group of intellectual property assets by listing the various types of intellectual property assets within the scope of the provisions. Section 170—which contains a special charitable tax deduction provision applicable to intellectual property—takes a true “grouping” approach, applying to “any patent, copyright . . . , trademark, trade name, trade secret, know-how, software . . . , or similar property, or applications or registrations of such property.”

Section 197—which imposes a mandatory fifteen-year amortization schedule for certain capitalized costs—does the same, applying to: “any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,” or “any trademark or trade name.” Interestingly, these provisions adopting a grouping approach avoid using the broader term “intellectual property.”

1. Deciding Whether the Tax System Should Adopt Tax Distinctions

Drafters of any tax legislation must consider the scope of the particular provision. Thus, a legal framework for intellectual property taxation should necessarily consider whether to adopt tax distinctions for intellectual property areas. A risk with adopting tax distinctions among different types of intellectual property is that the tax system may not be flexible enough to be applied to future innovations and changes in intellectual property areas.

Internet domain names are a prime example of an intellectual property movement that has outstripped the present tax system. Under the current intellectual property taxation regime, specific tax rules do not exist for domain names, valuable assets that emerged with the arrival of global

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176 I.R.C. § 197(d)(1)(C)(iii), (F) (emphasis added).

electronic commerce transactions on the Internet. Are domain names merely variations of traditional forms of intellectual property and other intangible rights to which the existing tax regime can be applied? As the authors have previously argued, domain names that function as source identifiers might be treated under the current tax rules applicable to trademarks, but generic domain names possess “inherent” goodwill not dealt with by the existing tax regime.\footnote{See Xuan-Thao N. Nguyen & Jeffrey A. Maine, \textit{Taxing the New Intellectual Property Right}, 56 Hastings L.J. 1 (2004).}

Another example in which an inflexible tax system maintaining distinct rules for different types of intellectual property is not easily applied is what we identify as the “Coca-Cola” problem. In business practice today, many different types of intellectual property are often bundled together, as many forms of intellectual property protection are available for a particular product or service.\footnote{Additionally, companies often bundle different types of intellectual property assets when they license in or out for the daily business operation. See generally Xuan-Thao Nguyen, \textit{Bankrupting Trademarks}, 37 U.C. Davis L. Rev. 1267, 1309-10 (2003) (observing the bundling of trademarks and other intellectual property assets in licensing practices); Gideon Parchomovsky & Peter Siegelman, \textit{Towards an Integrated Theory of Intellectual Property}, 88 Va. L. Rev. 1455 (2002) (noting the integration and simultaneous use of patents and trademarks in business practice and calling for a new theory of intellectual property to address the integration of different types of intellectual property).} This bundling phenomenon begs the question: How should a particular transaction involving integrated or bundled intellectual property assets be treated for tax purposes under an asset-specific tax regime that maintains distinct rules for different types of intellectual property?

There exists a “bundle” of intellectual property rights entangled and embodied inside and outside each Coca-Cola can or bottle. The \textit{trademark} Coca-Cola was worth about $66.47 billion in 2008.\footnote{Coca-Cola is estimated to be worth about $66.47 billion. See Best Global Brands of 2008, \textit{available at} http://www.interbrand.com/best_global_brands.aspx.} It is not an ordinary trademark; it is a brand with a large equity built through years of advertisements, distributions, and uses in commerce in the United States and worldwide.\footnote{Brand equity has been equated with the concept of goodwill and both are defined as “that which makes tomorrow’s business more than an accident. It is the reasonable expectation of future patronage based on past satisfactory dealings [that] gives [a business] a selling value above that of its leasehold, equipment and stock.” \textit{Edward S. Rogers, Good Will, Trade-Marks and Unfair Trading} 13 (1914).} The goodwill in the trademark has been created

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\footnote{See Xuan-Thao N. Nguyen & Jeffrey A. Maine, \textit{Taxing the New Intellectual Property Right}, 56 Hastings L.J. 1 (2004).}
\footnote{Additionally, companies often bundle different types of intellectual property assets when they license in or out for the daily business operation. See generally Xuan-Thao Nguyen, \textit{Bankrupting Trademarks}, 37 U.C. Davis L. Rev. 1267, 1309-10 (2003) (observing the bundling of trademarks and other intellectual property assets in licensing practices); Gideon Parchomovsky & Peter Siegelman, \textit{Towards an Integrated Theory of Intellectual Property}, 88 Va. L. Rev. 1455 (2002) (noting the integration and simultaneous use of patents and trademarks in business practice and calling for a new theory of intellectual property to address the integration of different types of intellectual property).}
\footnote{Coca-Cola is estimated to be worth about $66.47 billion. See Best Global Brands of 2008, \textit{available at} http://www.interbrand.com/best_global_brands.aspx.}
\footnote{Brand equity has been equated with the concept of goodwill and both are defined as “that which makes tomorrow’s business more than an accident. It is the reasonable expectation of future patronage based on past satisfactory dealings [that] gives [a business] a selling value above that of its leasehold, equipment and stock.” \textit{Edward S. Rogers, Good Will, Trade-Marks and Unfair Trading} 13 (1914).}
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over the years, and is attached and associated with the trademark.\textsuperscript{182}

The Coke bottle has a unique shape that deserves \textit{trade dress} protection.\textsuperscript{183} Indeed, courts have mentioned the Coke bottle as an example of trade dress worthy of legal protection.\textsuperscript{184} Trade dress protection extends to the packaging of a product, the overall look and feel of a product that signifies as a source in the eyes of the consumer.\textsuperscript{185} Protected trade dress enjoys a similar protection available to trademarks under federal and state laws.\textsuperscript{186} The distinctive red and white design on

\textsuperscript{182} Newark Morning Ledger Co. v. United States, 507 U.S. 546, 555-56 (1993) ("Although the definition of goodwill has taken different forms over the years, the shorthand description of goodwill as ‘the expectancy of continued patronage,’ provides a useful label with which to identify the total of all the imponderable qualities that attract customers to the business.").

\textsuperscript{183} See Gary Myers, \textit{Statutory Interpretation, Property Rights, and Boundaries: The Nature and Limits of Protection in Trademark Dilution, Trade Dress, and Product Configuration Cases}, 23 COLUM.-VLA U.L. & ARTS 241 (2005) (recounting that “not only is the name Coca-Cola protectable, but so is the red-and-white swirl packaging of its producer's cans and the distinctive shape of the old-fashioned Coke bottle”).

\textsuperscript{184} See Wal-Mart Stores, Inc. v. Samara Brothers, 529 U.S. 205, 215 (2000) (recognizing that “a classic glass Coca Cola bottle, for instance, may constitute packaging for those customers who drink the Coke and then discard the bottle, but may constitute the product itself for those consumers who are bottle collectors, or part of the product itself for those consumers who buy Coke in the classic glass bottle, rather than a can, because they think it more stylish to drink from the former.”).

\textsuperscript{185} See generally TrafFix Devices, Inc. v. Marketing Displays, Inc., 532 U.S. 23, 28 (2001) ("It is well established that trade dress can be protected under federal law. The design or packaging of a product may acquire a distinctiveness which serves to identify the product with its manufacturer or source; and a design or package which acquires this secondary meaning, assuming other requisites are met, is a trade dress which may not be used in a manner likely to cause confusion as to the origin, sponsorship, or approval of the goods."); Two Pesos, Inc. v. Taco Cabana, Inc., 505 U.S. 763, 775 (1992) (providing trade dress protection for the look and feel of a fast food restaurant). \textit{See also} 15 U.S.C. § 1125(a)(3) ("In a civil action for trade dress infringement under this chapter for trade dress not registered on the principal register, the person who asserts trade dress protection has the burden of proving that the matter sought to be protected is not functional.").

\textsuperscript{186} See generally Moseley v. V Secret Catalogue, Inc., 537 U.S. 418, 428 (2003) (stating that federal unfair competition law “broadly prohibits uses of trademarks, trade names, and trade dress that are likely to cause confusion about the source of a product or service."); Wal-Mart Stores, Inc. v. Samara Bros., Inc., 529 U.S. 205, 209 (2000) (observing that the federal Lanham Act extends protections to word marks “such as “Nike,” and symbol marks, such as Nike's “swoosh” symbol, but also “trade dress”-a category that originally included only the packaging, or “dressing,” of a product, and the design of a product.).
the Coke tin can today is easily recognizable; when a consumer walks to a beverage aisle, he or she has no difficulty recognizing a pack of Coke cans from the others. The distinctive red and white design is protected under trademark law.

The Coke formula is a well-kept trade secret that ensures the success of the beverage. Others have tried to imitate the brown color drink, but could not. Other brown drinks are sold under trademarks such as Pepsi-Cola, Dr. Pepper, and others, but none could approach the ubiquitous taste of Coke. There is no doubt that the trade secret of the Coke formula is very valuable.

A legal framework for intellectual property taxation should consider the most efficient manner to address the integration of intellectual property in business practices. Consider a transaction involving the bundling of intellectual property rights embodied inside and outside each Coca Cola can or bottle. A tax system that groups together various

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187 See Dana M. Herberholz, Curing Confusion: An Overview of the Regulatory Complexities of Obtaining Pharmaceutical Trademarks and Prescription for Reform, 8 MINN. J.L. SCI. & TECH. 97, 100 (2007) (commenting that the “protections of trademark law enable the supermarket customer to choose to purchase COCA-COLA® to the exclusion of other colas, knowing that the famous red label showcasing white letters refers to a particular and familiar brand of cola”).


189 See Coca-Cola Bottling Co. of Shreveport v. Coca-Cola Co., 107 F.R.D. 288 (D. Del. 1985) (finding that the Coke formulas are “one of the best-kept trade secrets in the world” and that they are kept locked away in an Atlanta bank vault which may “only be opened upon a resolution from the Company’s Board of Directors”).

190 See United States v. Williams, 526 F.3d 1312, 1323-24 (11th Cir. 2008) (noting that in a case involving Coca-Cola trade secrets the district court “focused on the severity of the harm that could have befallen Coca-Cola if the trade secrets had been sold to a rival, and the danger to the U.S. economy that these types of crimes pose”); Coca-Cola Co. v. Reed Industries, Inc., 864 F.2d 150 (Table) (Fed. Cir. 1988) (affirming the district court’s injunction against the defendants in a case brought by Coca-Cola for misappropriation of its Coke formulas); Xpel Technologies Corp. v. American Filter Film Distributors, 2008 WL 3540345, *5 (W.D. Tex. Aug. 11, 2008) (“Take for example the formula for making Coca-Cola. This formula is a trade secret possessed by The Coca-Cola Company. If a competitor surreptitiously eavesdropped on an internal conversation in which Coke employees were discussing this formula, and if this competitor then started using the improperly acquired formula in the making of its products, Coca-Cola would justifiably be upset.”).
intellectual property rights for tax purposes might be more easily applied in practice than a system that adopts separate tax rules for separate transactions involving differing types of intellectual property. The former approach (a grouping approach) would avoid questions over whether the tax results should be dictated by focusing on the trademark Coca-Cola, on the trade dress of the Coke can or on the trade secret of the Coke formula. A grouping approach would also eliminate messy allocation and valuation issues and disputes when it focused on all three of these rights, as one unified asset.

The current tax regime governing intellectual property adopts a grouping approach for many acquisitions of intellectual property (i.e., intellectual property acquired as part of the acquisition of assets constituting the acquisition of a trade or business). Section 197, which was enacted in 1993 to simplify tax depreciation rules for intangible property, adopts a single depreciation method (straight-line method) and a single recovery period (fifteen years) for the capitalized costs of acquiring many forms of intellectual property.\footnote{I.R.C. § 197. See \textsc{Staff of J. Comm. on Taxation}, 103d \textsc{Cong.}, Technical \textsc{Explanation of Tax \textsc{Simplification Act} of 1993} 147 (Comm. Print 1993) (explaining that Congress created section 197 to eliminate considerable confusion over the federal tax treatment of intangible assets).} Thus, a purchaser of the bundle of intellectual property rights embodied in the Coca-Cola product (trademark, trade dress, and trade secret rights) would amortize the total purchase price ratably over fifteen years.

In contrast to its treatment of intellectual property acquisitions, the current tax regime does not adopt a grouping approach for the sale of intellectual property; instead the Code contain special tax rules for the assignment of trademarks,\footnote{I.R.C. § 1253.} and relies on general tax rules for the assignment of trade secrets and trade dress rights.\footnote{I.R.C. §§ 1221, 1222, 1231.} Thus, the seller of a bundle of intellectual property rights embodied in the Coca-Cola product would be required to allocate the sales price among the various intellectual property rights and apply different tax rules to each in order to determine the tax results.\footnote{Gain from the sale of the trademark would be ordinary income if payments were contingent on the productivity, use, or disposition of the mark, or if payments were non-contingent and the transferor retained any significant power, right or continuing interest with respect to the subject matter of the mark. In contrast, gain from the sale of the trade secret most likely would be treated as capital gain under general capital gain}
of the intellectual property rights for acquisition purposes.

The bundling problem, as highlighted in the Coca-Cola example above, also exists with respect to billboards. Each billboard, advertising, for example, Nike products, Marlboro cigarettes, or Wrigley gum, is a copyrighted work of authorship. The creators express their ideas in a tangible medium that conveys a message imbedded in the depiction. The author of a billboard may be a freelance artist or an employee for an advertising agency. The contractual agreements between the product company and the author or advertising agency set forth the identity of the copyright owner. The billboard and its associated costs contribute to the building of the recognition, reputation, and goodwill embodied in the trademark or trade dress of each featured product. This bundling of intellectual rights in billboards raises interesting questions. For instance, how should billboard development costs be treated for tax purposes? Should costs be viewed as copyright development costs? Should such costs be treated as part of the development of a trademark or trade dress? Or, should costs be treated as general advertising expenditures? Under the current tax regime governing intellectual property, different tax results would occur depending on the answer. A more efficient regime would produce similar results regardless.

provisions.

195 See Kleier Advertising, Inc. v. Premier Pontiac, Inc., 921 F.2d 1036 (10th Cir. 1990) (involving copyright infringement brought by an advertising company against an automobile dealership and advertising agency for the allegedly infringing use of the copyrighted billboard).

196 Id. In Kleier Advertising, Inc., the author of the copyrighted billboard “Beat the Pants” advertisement program was an advertisement agency with many employees and the billboard program “has been a traffic-stopping success in forty geographical markets throughout the United States and Canada.” Id.

197 Id. (noting that if a company wants to use the “Beat the Pants” billboard ad, it must obtain a license from the advertisement agency).

198 Under the current intellectual property taxation regime, copyright development costs incurred by a corporation are not currently deductible, but must be capitalized. I.R.C. §§ 263(a), 263A(a)-(b); Treas. Reg. § 1.263(a)-4(b)(1)(ii), (iii), -4(d). The costs of building up the goodwill value in a trademark are generally treated as deductible advertising costs, see Rev. Rul. 92-80, 1992-2 C.B. 57, but fees paid to the Trademark Office for trademark protection are not currently deductible. Treas. Reg. § 1.263(a)-4(l), Ex. 9(i). The actual costs of building the tangible property (the physical build board itself), are not deductible but must be capitalized. Rev. Rul. 92-80, 1992-2 C.B. 57.
Computer software is another classic example of the bundling of rights in today’s economy. For instance, Microsoft Windows is a group of complex software programs covered by many copyrights. Each time a newer version of the software is created, there is a potential new copyright. Additionally, certain functions for Windows software programs are covered by patents. Moreover, there is proprietary information and know-how embodied in Windows that is protected by trade secret law. The name “Windows” is a known trademark, identifies the products widely installed in most computers and used by millions. The four curving, colorful panels of the Windows logo are also entitled to protection under trademark law. An efficient tax system should be able to address a transaction involving this complex network of software as seen in Windows.

Another example of the “Coca-Cola” bundling problem is video games. In 2008, the revenue for the games reached $21.33 billion, and

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200 See generally Mark F. Radcliffe & Nels R. Nelsen, Code to Code: Perfecting Security Interests in Copyrights: The Confusion Continues, AM. BANKR. INST. J., available in 1997 ABI JNL. LEXIS 236 (analogizing a computer software program to a layer cake, each layer representing a “new version or revision of the software . . . protected by a separate copyright”).

201 See Benjamin J. Kormos, Giving Frankenstein a Soul: Imposing Patentee Obligations, 21 I.P.J. 309, 341 (2009) (reporting that as of 2007 Microsoft held more than 6,000 software patents).

202 See Robert W. Gomulkiewicz, Conditions and Covenants in License Contracts: Tales From a Test of the Artistic License, 17 TEX. INTELL. PROP. L.J. 335, 338 (2009) (observing that Microsoft and other software companies rely on trade secret protection afforded to software programs distributed in binary form).


205 See 2008 US Video Sales Reached $21.33 Bln, IT FACTS, Jan. 15, 2009,
the number has been projected to increase to $48.9 billion by 2011. A recent study revealed that the video games industry employed 24,000 people in 31 states, and in 2006 these employees received $2.2 billion in compensation. Another study reported that the video games industry is growing faster than other industries and has surpassed the ailing music industry. The creators, publishers, and distributors of video games rely on the bundling of different types of intellectual property for the daily operation of their businesses. For example, game companies seek patent procurements for new game functions and initiate infringement litigation against others for violation against the patent-related video games. Likewise, game companies utilize trademark law to protect the goodwill accumulated in the names of the games and to enforce the trademarks against unauthorized use by others of similar or identical games that may cause a likelihood of consumer confusion. In addition, game companies may rely on trade dress law to protect the look and feel of their game displays. Most often, the game companies rely on copyright law.

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208 See Szalai, supra note 206 (reporting that the “video game sector will remain one of the above-average growth segments of the global entertainment industries through 2011, with global games spending set to exceed music spending this year”).


210 See generally Nintendo of America, Inc. v. Brown, 94 F.3d 652 (Table) C.A.9 (Ariz. 1996) (noting that the “record supports the district court's determination that consumer confusion would occur about the origin of the video games at issue because they were virtually identical to the games sold by Nintendo”). See also Sony Computer Entertainment, Inc. v. Connectix Corp., 203 F.3d 596 (9th Cir. 2000) (analyzing trademark dilution claim in a case involving console video games).

211 See generally Incredible Technologies, Inc. v. Virtual Technologies, Inc., 400 F.3d 1007 (7th Cir. 2005) (copyright claims in the video game instructions and display,
for the protection of their games and prohibition of infringements. In reality, video games are all about software; indeed, the industry terms it “entertainment software.”

These four examples of bundling in the beverage, advertising, software, and game industries serve as reminders that companies operate today with reliance on many different types of intellectual property. These examples are not the exceptions; they are the norms. For example, in the biotech or biopharma industry, drug companies rely on patents and trade secrets for the protection of their research, development, and invention of certain drugs. Drug companies advertise the drugs and they rely on copyright, trade dress, and trademark for their various advertising campaigns. Also, to market and sell their drugs, they will use trademarks along with pamphlets and instructions. That means the drug companies must rely on trade dress, trademarks, and copyrights to fulfill these tasks.

A tax system flexible enough to be applied to future innovations and intellectual property movements, such as the integration and simultaneous use of intellectual property, would achieve greater clarity of tax results, as well as administrative efficiency.

See generally Wakefield v. The Walt Disney Co., 321 Fed.Appx 685 (9th Cir. 2009) (copyright protection and infringement claims of Kingdom Hearts video games); Sony Computer Entertainment America, Inc. v. Bleem, LLC., 214 F.3d 1022 (9th Cir. 2000) (Manufacturer of console video games and game disks brought action against developer of “software emulator” permitting users to play console games on a personal computer, alleging that developer's use of “screen shots” from manufacturer's games in developer's advertising violated manufacturer's copyright); Frybarger v. Int'l Bus. Machs. Corp., 812 F.2d 525, 528 (9th Cir.1987) (analyzing copyright infringement claim between two video games). See also Nintendo of America, Inc. v. Brown, 94 F.3d 652 (Table) C.A.9 (Ariz. 1996) (affirming copyright and trademark infringement claims because the defendant’s games were identical to the plaintiff’s games).

See generally Entertainment Software Assoc., Economic Data, http://www.theesa.com/facts/econdata.asp (noting that the entertainment software is a fast growing segment of the industry).


2. Determining a Basis for Tax Distinctions

If the tax system adopts tax distinctions among different types of intellectual property rights, a legal framework for tax rules should address the extent to which substantive differences among forms of intellectual property justify different tax results for each form to minimize tax inequities. While all types of intellectual property share certain common characteristics, real substantive differences also exist among the forms. A patent is issued for twenty years and a copyright is in force for the life of the author plus 70 years (or 95 or 120 years in the case of a hired creator); the duration of a trademark or trade name protection is not limited but lasts as long as it is used in commerce. To what extent, if any, should these and other substantive differences justify different tax results? Under present rules, the receipt of contingent payments in patent and copyright transfers is treated vastly different from the receipt of contingent payments in trademark and trade name transfers. One commentator has argued that the only major substantive difference among these forms—duration—does not justify differing effects of contingent payments. But perhaps there are other substantive differences supporting differing tax results? An appropriate legal framework would focus attention on this issue and yield fewer perceived tax inequities.

If tax distinctions are deemed justified based on substantive differences among intellectual property forms, a framework should question whether the different types of intellectual property are being treated in an appropriate manner vis-à-vis one another. Assume, for example, that it is determined that patents and copyrights should be treated as equals for tax purposes due to their substantive similarities (e.g., they serve to promote science and the art), and that, conversely, trademarks should be treated differently for tax purposes (because they serve a different purpose of protecting consumers and trademark owners). A legal framework for analyzing intellectual property tax rules would question whether patents and copyrights were being treated in an

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216 See supra note 33 and accompanying text.

217 See supra notes 70-72 and accompanying text.


219 See supra notes 130-156 and accompanying text.

220 See supra notes 161-165 and accompanying text.
appropriate manner compared to trademarks to achieve true equity.

As an alternative to focusing on the legal attributes of intellectual property and basing tax distinctions upon substantive differences among identified forms, a tax framework might base tax distinctions on the purposes for which intellectual property assets serve. For example, instead of developing separate rules for identified intangibles (patents, trade secrets, copyrights, trademarks, trade names, computer software), creating legal definitions, and carving out exceptions, a tax system could develop separate rules for “technology-based intangible assets,” “marketing-based intangible assets,” and “artistic-based intangible assets.”

Basing tax distinctions upon intellectual property uses, as opposed to intellectual property definitions, might yield a more flexible tax system capable of handling future innovations and intellectual property movements. As noted above, special tax rules governing intellectual property do not currently address domain names. It might be suggested that domain names that function as trademarks be treated as such under current tax rules. But under the proposed framework, they might fall within the category of “technology-based intangible assets” and be treated consistently with other intangible assets falling under that category, such as patented and unpatented technology, trade secrets, etc. As with domain names, current tax rules do not specifically deal with websites. Instead of treating the various components of a website differently based on current tax treatment of software, copyrightable content, and non-copyrightable content, the proposed framework might treat the website as

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221 With respect to accounting for business combinations, this is the approach that was adopted by the Financial Accounting Standards Board (FASB). See FASB Statement 141 (Business Combinations), FASB Statement 142 (Goodwill and Other Intangible Assets).

222 See supra note 178 and accompanying text.

223 See Nguyen & Maine, supra note 178.

224 Under the current tax rules, taxpayers and advisors are left with questions, such as: Should the costs relating to the development of a Web site be treated the same as software development costs? How should the costs of creating or purchasing content for Web sites be treated? Does it make a difference if some Web site content is copyrightable or non-copyrightable? If Web sites are considered variations of existing intellectual or intangible property rights to which the existing tax law can be adopted, then the tax treatment of Web sites might depend on the Web site’s components (e.g., software, copyrightable content, non-copyrightable content). This approach is not easily applied in practice.
a whole as a “marketing-related intangible asset.” Such an approach might also eliminate problems caused by the bundling of intellectual property in business practice.

A tax system emphasizing intellectual property uses, as opposed to legal attributes, might yield more rational tax distinctions. Currently, for example, trademark and trade secret acquisition costs are treated the same for tax purposes. However, it might be justified to treat a trade secret used as a technology-based intangible asset differently from a trademark used as a marketing based intangible asset. In addition, it might be justified to treat a copyright that is classified as an artistic-related intangible (e.g., a book, play, or musical work) differently from a copyright that classified as a marketing-related intangible asset (advertising materials). Such an approach would ensure consistency. For example, it would mandate that a copyright on a book (an artistic-related intangible) would be treated consistently with a copyright on a musical work (also an artistic-related intangible). These copyrights are not treated similarly under current law.

Such a system focusing on intellectual property uses would also eliminate the debate over whether emphasis should be on protections available or protections actually obtained. Certain property—such as computer software or a design patent—is eligible for more than one type of intellectual property protection. This begs the question whether tax consequences should be affected by the protections available (e.g., patent, copyright, trade secret), or whether tax consequences should depend on the actual protections obtained. Consider the tax treatment of an assignment of computer software or a design patent. Under current tax rules, a capital asset does not include any copyright in the hands of the person who created it. An interesting question that arises is whether this copyright exclusion applies when property, such as a design patent or computer software, is both patentable and copyrightable. Under current rules, the copyright exclusion does not apply if “a patent or an invention, or a design . . . may be protected only under the patent law and not under the copyrightable law.” Under this approach, design patents, which are eligible for both patent and copyright protection, would be subject to the copyright exclusion. Likewise, computer software, which is copyrightable but often protected through a trade secret agreement, would also be subject to the copyright exclusion.


226 Treas. Reg. § 1.1221-1(c)(1).

227 For criticism of the current approach, see Charles Falk, Tax Planning for the
property uses would eliminate this outcome.\textsuperscript{228}

C. Reconciling the Tax System’s Treatment of Intangible Intellectual Property with Treatment of Tangible Property

Tax rules for intangible intellectual property differ substantially from tax rules for tangible property. As examples, the costs of purchasing certain machines and equipment for active use in businesses are immediately deductible,\textsuperscript{229} but the costs of purchasing intellectual property assets for use in businesses are not, and must be capitalized.\textsuperscript{230} The purchase price for a computer can be written off over five years,\textsuperscript{231} but the purchase price for custom software to run the computer must be written off over either three years or fifteen years, depending on how the software was acquired.\textsuperscript{232} A charitable contribution of a building provides the donor with a tax deduction equal to the fair market value of the building,\textsuperscript{233} whereas a charitable contribution of a patent provides the donor with a deduction equal to the donor’s basis.\textsuperscript{234} In these and other instances, the current tax system treats intellectual property inconsistently with, and less favorably, than tangible property. The inconsistencies raise interesting policy questions. Does it make sense, for example, that the costs of tangible assets associated with advertising (e.g., billboards) must be


\textsuperscript{228} Interestingly, while the tax treatment of assignments of software and design patents is impacted by intellectual property protections, the tax treatment of developments and acquisitions of software and design patents is not. Costs of software development, for example, are generally treated the same (deductible) regardless of the method of protection available or obtained. Rev. Proc. 2000-50, 2000-50 C.B. 601, updating Rev. Proc. 69-21, 1969-2 C.B. 303. A legal framework emphasizing intellectual property uses would avoid such distinction in the current tax system.

\textsuperscript{229} I.R.C. § 179 (allowing taxpayers to elect to expense the costs of certain tangible property).

\textsuperscript{230} I.R.C. § 263(a); Treas. Reg. § 1.263(a)-4(b)(1)(i), -4(c)(1).

\textsuperscript{231} I.R.C. §§ 167, 168(c), (e)(3)(B).

\textsuperscript{232} I.R.C. §§ 167(f) (providing a three-year recovery period for separately acquired computer software), 197 (providing a fifteen-year recovery period for software acquired as part of the acquisition of a trade or business).

\textsuperscript{233} I.R.C. § 170(a); Treas. Reg. § 1.170A-1(c).

\textsuperscript{234} I.R.C. § 170(e)(1)(B)(iii).
capitalized, but that the costs of advertising materials on which copyright protection is obtained can be expensed? Where a billboard has a short life and likely depreciates in value, copyrighted advertising material has a long legal life and often appreciates in value. An appropriate legal framework for intellectual property tax rules should consider the appropriateness, if any, of distinctions between the tax treatment of tangible and intangible capital.

V. CONCLUSION

Federal tax rules governing intellectual property evolved in the absence of an appropriate legal framework for the intersection of intellectual property and taxation schemes. As a result, the current intellectual property tax regime is flawed on several grounds. For instance, although some aspects of the tax scheme are harmonious with and promote the intellectual property scheme, others hinder it and stifle desirable intellectual property activity. Furthermore, tax distinctions in the current tax system (i.e., different rules for different types of intellectual property) have produced an inflexible tax system not easily applied to future innovations and intellectual property movements such as transactions involving integrated or bundled intellectual property. A rational, coherent legal framework is needed for the development of an intellectual property tax system that does not violate fundamental principles of tax policy.