

# FLORIDA TAX REVIEW

VOLUME 5

2002

NUMBER 8

## It Does Not Compute: Copyright Restriction on Tax Deduction for Developer's Donation of Software

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## I. INTRODUCTION

Great amounts of wealth can be represented by intellectual property (“IP”), including computer software. Computer software creators, and other inventors, artists and authors, may desire to enthusiastically support their favorite charitable endeavors. The tax consequences for the creative genius donating his or her IP to charity will depend on whether his or her creation is protected by patent, trade secret or trademark on the one hand, or copyright on the other. In general, the donor of a patent, trade secret or trademark enjoys favorable tax treatment – he or she is entitled to claim an income tax deduction for the full fair market value of the IP donated. In contrast, as a result of the Tax Reform Act of 1969, the donor of a copyright is not allowed to claim a full fair market value deduction – instead, he or she may claim a deduction only for his or her cost basis in the copyright (which may be very small, or nothing). The following example demonstrates the different income tax results possible.

Example #1: Leonardo da Vino is a multi-talented genius who has written a sensational book titled “People Will Be Talking About Me for Centuries,” which has the literary world abuzz. The book cost Leo \$800 to prepare,<sup>1</sup> and all rights (including the copyright) to the book would sell for \$10 million. In addition, Leo is also a man of science and has developed new technology that could revolutionize the wine-making industry. All rights to his invention (including the related patent) would sell for \$10 million. If Leo donates all rights to his new “vino” technology to his favorite Church (which will assign all rights in the technology to a commercial firm for \$10 million and use the cash to build shelters for the homeless), Leo can be entitled to a charitable income tax deduction of \$10 million.<sup>2</sup> In

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1. Leo’s costs consisted of paper, pencils, and a small amount of depreciation for his computer equipment. As one commentator has noted, “the ratio of cost to market value for creative compositions of any significant market value is very small.” Note, Tax Treatment of Artists’ Charitable Contributions, 89 Yale L. J. 144, 148 (1979). For a painter, the greatest cost is often the frame – as a result, the artist would receive a similar charitable income tax deduction whether he or she contributes an empty frame or a framed valuable picture. *Id.* For an author, the charitable deduction may be limited to the cost of pencils and paper. *Id.* (estimating the cost of a 5,000 page Herman Wouk manuscript at \$30 to \$40).

2. Leo’s ability to claim the deduction may be limited by the 3%/80% restriction of IRC § 68(a) (which is discussed in the text accompanying *infra* notes 132-134), and the 30% of adjusted gross income limitation of IRC § 170(b)(1)(C)(i) (which is discussed in *infra* notes 135-140 and accompanying text). Charitable deductions that cannot be claimed because of the 30% limitation can be carried forward for up to 5

contrast, if Leo donates all rights to the book to his favorite Church (which will sell all the rights relating to the book for \$10 million and establish homeless shelters), Leo will be entitled to a charitable income tax deduction of only \$800.

Computer software can be eligible for several different types of IP protection. Initially, computer software was protected by trade secret laws. Gradually, software was considered a literary work eligible for copyright protection (in 1980 the Copyright Act was amended to include specific references to computer software). Now certain features of software may be eligible for patent protection. As a result, software may be eligible for protection under trade secret law, copyright, and/or patent law.

There are no reported cases or rulings considering a charitable contribution by an individual amateur<sup>3</sup> software developer. One case addresses a similar issue, and unfortunately concludes that since computer software is “eligible” for copyright protection, the copyright rule should apply, resulting in adverse tax consequences for the software developer.<sup>4</sup> This approach fails to recognize that software may also be eligible for patent protection, and further ignores rules and policies which have traditionally provided favorable tax consequences to donors who contribute patent rights to charity. The situation involving software eligible for “over-lapping” IP protection (such as copyright and patent protection) is illustrated by the following example:

Example #2: As a result of intensive study of the wildlife around the Padre Island area for many years, world famous marine biologist Texas Hank has developed new software called “Be Where They’re Biting.” This software will revolutionize the commercial fishing industry. The user will enter certain information regarding weather conditions, air and water temperatures, and geographic conditions, and choose the type(s) of fish desired, and “Be Where They’re Biting” will provide reliable projections on where and when the fish will be biting and preferred fishing techniques. The software will not only reduce costs for the commercial firms, but will also reduce environmental and ecological damage that results from

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years. Id. IRC § 170(b)(1)(C)(ii). Unless otherwise indicated, all statutory references in the text of this Article refer to the Internal Revenue Code of 1986, as amended.

3. The word “amateur” refers to a developer who does not hold computer software as inventory for sale to customers in the ordinary course of his or her trade or business. See IRC § 1221(a)(1).

4. *Levy v. Commissioner*, 64 T.C. Memo (CCH) 534, T.C. Memo (RIA) ¶ 92,471 (1992).

catching and then discarding unwanted fish. Texas Hank spent \$10,000 developing the software and could sell the software (and all related rights) to a commercial firm for \$100 million, but he would prefer to donate the software (and all related rights) to his favorite religious denomination which would sell the software (and all related rights) for \$100 million and use the money to help the poor. The literary elements of the software (the object code, the source code, and the manuals) would be eligible for copyright protection, and other features of the software (the process and method for assembling and analyzing the data and reaching the conclusions) would be eligible for trade secret or patent protection. As discussed in this Article, a Tax Court case<sup>5</sup> indicates that since the software would be eligible for copyright protection, Texas Hank would be entitled to claim a charitable deduction of only \$10,000 (the amount of his cost in developing the software) upon a charitable donation of the software. For the reasons discussed in this Article, the author believes that Texas Hank should be entitled to a charitable income tax deduction for the full fair market value of the software (\$100 million) upon a charitable donation of the software.

This Article will consider: (i) the various types of intellectual property rights and the methods for transferring those property rights to charity; (ii) the tax consequences to a charity exploiting those rights; (iii) the various restrictions that apply when claiming an income tax charitable deduction; (iv) the application of the current income tax rules to charitable gifts of patents, trade secrets, trademarks and copyrights in general; (v) the tax treatment of an amateur software developer's donation of computer software to charity under current law and the proper tax treatment of such donations; and (vi) proposals to change the current rules so that an amateur software developer would be able to claim an income tax deduction for the full fair market value of donated software when the software is eligible for patent protection.

## II. TYPES OF INTELLECTUAL PROPERTY AND METHODS OF TRANSFER

This Section will describe four types of intellectual property rights (patent, trade secret, trademark and copyright)<sup>6</sup> and the methods for donating

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5. *Id.*

6. While other types of intellectual property, such as rights of publicity, may raise interesting issues for the owner who desires to donate those rights to charity, we will save those issues for another day.

such rights to charity. This Section will then discuss certain creations (namely, computer software, designs, and characters) which are eligible for more than one type of IP protection.

#### A. Patents

Patent protection is authorized by Article I, Section 8, Clause 8 of the U.S. Constitution, which gives Congress the power “[t]o 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,” and is governed by federal law. The subject matter that may qualify for a “utility patent” is a “process, machine, manufacture, or composition of matter, or any new and useful improvement thereof,”<sup>7</sup> meeting certain conditions. The subject matter that may qualify for patent protection is broad – the Congressional Committee Report accompanying the 1952 Patent Act “inform[s] us that Congress intended statutory subject matter to ‘include anything under the sun that is made by man.’”<sup>8</sup>

An invention must meet three major requirements to be eligible for a utility patent. An invention must: (i) have utility;<sup>9</sup> (ii) be novel;<sup>10</sup> and (iii) be non-obvious.<sup>11</sup> “Utility” requires that the knowledge or ideas be reduced to a useful product or process.<sup>12</sup> “Novelty” means that the invention must be new and different from what was previously known or used. “Non-obvious” requires that it must be more than an obvious variation from what was previously known (with reference to a person of ordinary skill in the field of the invention).

In addition to utility patents, there are also design patents<sup>13</sup> and plant patents.<sup>14</sup> Design patents can protect the aesthetic appearance of a product.

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7. 35 U.S.C. § 101.

8. See *Diamond v. Chakrabarty*, 447 U.S. 303, 309 (1980) (quoting S. Rep. No. 1979, 82d Cong., 2d Sess., 5 (1952), reprinted in 1952 U.S.C.C.A.N. 2394, and H.R. Rep. No. 1923, 82d Cong., 2d Sess., 6 (1952)).

9. 35 U.S.C. § 101 (the subject matter must be “useful”).

10. *Id.* § 102 (“A person shall be entitled to a patent unless – (a) the invention was known or used by others in this country, or patented or described in a printed publication in this or a foreign country, before the invention thereof by the applicant for patent . . .”).

11. *Id.* § 103 (whether the invention is “obvious” is judged from the perspective of a “person having ordinary skill in the art to which said subject matter pertains.”).

12. See *Brenner v. Manson*, 383 U.S. 519, 534 (1966) (“The basic *quid pro quo* contemplated by the Constitution and the Congress for granting a patent monopoly is the benefit derived by the public from an invention with substantial utility.”).

13. 35 U.S.C. § 171.

14. *Id.* § 161.

The term of a U.S. utility patent begins on the date the patent is issued and ends 20 years from the date the patent application is filed.<sup>15</sup> A design patent has a term of 14 years from the date of grant.<sup>16</sup> A patent allows the owner to prevent others from using, making, offering to sell or selling the invention during the patent term, either through an action for injunctive relief or money damages.<sup>17</sup> The patent holder can even prevent someone who later independently discovers the invention from making, using, offering to sell, or selling the invention during the term of the patent.

When a patent is issued, the patent application is made public. In addition, a patent application will be made public 18 months after it is filed if the patent has not been issued by that time.<sup>18</sup> A patent provides the inventor (and/or his or her licensee or assignee) with a limited monopoly during the term of the patent. When the patent expires, the invention may be produced and used by anyone because it has been publicly disclosed and the term of patent protection has ended.

Patents have the attributes of personal property<sup>19</sup> and may be assigned by a written instrument.<sup>20</sup> Pending applications may also be transferred by assignment. The assignment, grant, or conveyance should be recorded with the U.S. Patent and Trademark Office (“PTO”) within three months of execution; otherwise, a subsequent purchaser of the patent (for valuable consideration) without notice of the prior assignment can become the owner of the patent.<sup>21</sup> The patent holder (or applicant) may also transfer rights by a license. For example, the patent owner may license another firm to make, use, and sell products based on the patent in a specified geographic area for a particular period of time.

### B. Trade Secrets

In contrast to the patent and copyright protections available under federal law, trade secrets are protected under state law. As of July 1, 2000,

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15. Id. § 154(a)(2). The term can be extended if the Patent and Trademark Office delays in the prosecution of the patent. Id. § 154(b).

16. Id. § 173 (a design patent cannot be renewed or extended).

17. Id. § 271 (a patent also allows the patentee to prevent the importation of infringing goods); §§ 281, 283, 284 (treble damages may be awarded) and 285 (attorneys fees may be awarded in “exceptional cases”).

18. Id. § 122(b)(1) (unless the inventor represents that he or she will not seek patent protection outside the U.S.).

19. Id. § 261.

20. Id. If the assignor’s signature is notarized, it will be “prima facie evidence of the execution of [the] assignment, grant or conveyance of [the] patent or application for patent.” Id.

21. Id.



forty-three states and the District of Columbia have adopted the Uniform Trade Secrets Act (“UTSA”) (several of those states have adopted the UTSA with modifications).<sup>22</sup> The subject matter that may qualify for trade secret protection is extremely broad. The UTSA defines a trade secret as information that: (i) derives independent economic value, actual or potential; (ii) is not generally known and is not readily ascertainable by proper means;<sup>23</sup> and (iii) is the subject of reasonable efforts to maintain the secrecy of the information under the circumstances.<sup>24</sup> Any information meeting these standards is eligible for trade secret protection. Many valuable innovations can be profitably exploited and protected as trade secrets but would not be eligible for patent protection. In some situations, inventors may prefer trade secret protection, and decide not to apply for patent protection.<sup>25</sup> Initially, the primary method for protecting computer software was trade secret protection,<sup>26</sup> and presumably trade secret protection could be available today for many software programs.

A key difference between trade secret protection and patent or copyright protection is the duration of protection. Patent and copyright protection last for a fixed time period.<sup>27</sup> Trade secret protection can last forever

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22. 14 U.L.A., 2001 Supp., 177. Tennessee adopted the UTSA effective July 1, 2000. The seven states which have not adopted the UTSA as of July 1, 2000 are Massachusetts, New Jersey, New York, North Carolina, Pennsylvania, Texas and Wyoming.

23. “Proper means” for acquiring another’s trade secret include: (i) discovering the information by independent research, and (ii) reverse engineering. See *E. I. duPont deNemours & Co. v. Christopher*, 431 F.2d 1072 (5th Cir. 1970), cert. denied 400 U.S. 1024 (1971).

24. The term “trade secret” is defined in UTSA § 1(4), reprinted in 14 U.L.A., 438 (1990).

25. In *Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470 (1974), the inventor chose trade secret protection over patent protection, and the U.S. Supreme Court concluded that state law trade secret protection was not preempted by federal patent law. It should be noted that the inventor who has a choice between patent protection and trade secret protection is subject to two important deadlines. If the inventor files for patent protection, and fails to withdraw the application before the earlier of: (i) when the patent is issued, or (ii) 18 months after the application is filed (unless the inventor seeks no foreign patent protection), the invention will be disclosed to the public and trade secret protection will no longer be available. 35 U.S.C. § 122(b). On the other hand, if the inventor fails to file a patent application within one year of the first public use of the invention (or within one year of the date the invention was first put on sale), patent protection will no longer be available. *Id.* § 102(b).

26. See text accompanying *infra* notes 68-71; *University Computing Co. v. Lykes-Youngstown Corp.*, 504 F.2d 518 (5th Cir. 1974).

27. The duration of a utility patent generally begins on the date the patent is issued and ends 20 years from the date of filing the patent application. 35 U.S.C. § 154(a)(2). In regards to the duration of a copyright, see text accompanying *infra* notes 60-62.

if the information remains a secret (but will disappear if the “secret” is discovered by proper means).

In assigning or otherwise transferring a trade secret to a charity, the parties would want to enter into a contract providing that the information would continue to be a secret. One court has stated that the key to transferring trade secret protection is that the charity should acquire the right to prevent others from disclosing the information, and the right to sue (and collect from) those who misappropriate the trade secret.<sup>28</sup>

As with other intellectual property rights, the charity may exploit the trade secret by either: (i) licensing others to use the information,<sup>29</sup> or (ii) selling its entire interest in the trade secret to another party.

### C. Trademarks

Any “word, name, symbol or device” used in commerce that indicates the source of goods, and distinguishes those goods from others can be a trademark.<sup>30</sup> Service marks are marks that identify the source of services rather than goods.<sup>31</sup> Trademarks and service marks can inform consumers about the quality (and other characteristics) of the goods because the mark identifies the source of the goods or services. Product packaging that is not functional and is

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28. *E.I. du Pont de Nemours & Co. v. United States*, 288 F.2d 904, 911 (Ct. Cl. 1961). The Court of Claims concluded that the transfer of these rights supported the assertion that the disclosure of the information was a transfer of property (in the form of a trade secret) rather than the mere providing of services (such as when an attorney gives advice to a client, or when a doctor talks to a patient). Presumably the mere disclosure of the information from the inventor to the charity will not jeopardize the trade secret protection, particularly if the inventor agrees that he or she will not disclose the information, and transfers all of his or her rights relating to the invention to the charity. See *Metallurgical Industries Inc. v. Fourtek, Inc.*, 790 F.2d 1195 (5th Cir. 1986) (disclosure pursuant to a confidentiality agreement that is necessary to exploit the trade secret will not prevent the information from being a “secret”).

29. The “licensee” would be required to sign a confidentiality agreement, and would agree that its only right would be to use the information for a specified purpose, such as manufacturing goods in a specific geographic location for a specified period of time.

30. 15 U.S.C. § 1127, Lanham Act § 45. “Since human beings might use as a ‘symbol’ or ‘device’ almost anything at all that is capable of carrying meaning, this language, read literally, is not restrictive.” *Wal-Mart Stores, Inc. v. Samara Brothers, Inc.*, 529 U.S. 205, 209 (2000) (quoting *Qualitex Co. v. Jacobson Products Co.*, 514 U.S. 159, 162 (1995)).

31. 15 U.S.C. § 1127, Lanham Act § 45.

distinctive may qualify for trademark protection as “trade dress.”<sup>32</sup> The shape or design of a product itself may also qualify for trademark protection (as trade dress),<sup>33</sup> but unlike product packaging, product design cannot be inherently distinctive, so that trade dress protection is only available if the product design has acquired secondary meaning.<sup>34</sup>

The mere use of a mark (without PTO registration) can provide some protection against the use of a confusingly similar mark by competitors. The use of an “unregistered” mark can give the user, within the geographic area of actual use and the “zone of natural expansion,” the right to prevent others from adopting and using a confusingly similar mark.<sup>35</sup>

Greater rights and protections are available if the mark is registered with the PTO. Key advantages to federal registration include: (i) the registration gives the registrant nationwide constructive use and constructive

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32. Product packaging can be distinctive because it is either: (i) inherently distinctive, *Two Pesos, Inc. v. Taco Cabana, Inc.*, 505 U.S. 763 (1992), or (ii) has acquired secondary meaning. In *Two Pesos*, the U.S. Supreme Court concluded that the trade dress of a restaurant can be inherently distinctive.

33. *Wal-Mart Stores, Inc. v. Samara Brothers, Inc.*, 529 U.S. 205, 209 (2000) (“The breadth of the definition of marks registrable under § 2, and of the confusion-producing elements recited as actionable by § 43(a), has been held to embrace not just 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, but in recent years has been expanded by many courts of appeals to encompass the design of a product.”).

34. *Id.* at 214 (“[P]roduct design cannot be protected under [Lanham Act] § 43(a) without a showing of secondary meaning.”). “Secondary meaning” exists if the plaintiff can “show that the primary significance of the term in the minds of the consuming public is not the product but the producer.” *Kellogg Co. v. National Biscuit Co.*, 305 U.S. 111, 118 (1938)(quoted in *Zatarain’s, Inc. v. Oak Grove Smokehouse, Inc.*, 698 F.2d 786, 791 (5th Cir. 1983)). Also if the trade dress is not registered on the PTO’s principal register, “the person who asserts trade dress protection has the burden of proving that the matter sought to be protected is not functional”. 15 U.S.C. § 1225(a)(3), Lanham Act § 43(a)(3).

35. See J. Thomas McCarthy, *McCarthy on Trademarks and Unfair Competition*, § 26.20, p. 26-31 (discussing the “zone of natural expansion,” and citing *Burger King of Florida, Inc. v. Brewer*, 244 F.Supp. 293 (W.D. Tenn. 1965)). 15 U.S.C. § 1125(a), also known as § 43 of the Lanham Act, provides a federal cause of action for infringement of unregistered marks. The owner must use the mark in commerce to have a cause of action under § 43(a). If the mark has not been used in commerce, *common law* protection for the infringement of the unregistered mark is still available, but only in areas of actual use and the zone of natural expansion. This assumes that the user is the first user (also called the “senior user”) in that geographic area. If there is a prior user (who has not abandoned the mark) the new user (often called the “junior user”), may be sued for infringement under section 43(a) of the Lanham Act and/or state trademark law.

notice, which cuts off potential rights of any future users of the same or similar mark;<sup>36</sup> (ii) the mark may become “incontestable” after five years, which will eliminate a number of defenses which others may raise if they use the same or similar mark;<sup>37</sup> and (iii) it provides the right to bring a federal cause of action without regard to diversity or minimum amounts in controversy.<sup>38</sup> Traditionally, an application for federal registration could not be filed until the mark was used “in commerce.”<sup>39</sup> As a result of the Trademark Law Revision Act of 1989<sup>40</sup> an application can be filed before the mark has actually been used in commerce if in good faith the applicant has a “bona fide intention . . . to use [the] trademark in commerce.”<sup>41</sup> Upon the filing of an “intent to use” application, the PTO will issue a “notice of allowance,” rather than registering the mark.<sup>42</sup> If the applicant then files a verified statement that the mark has in fact been used in commerce within six months of the application (the six month period can be extended to one year automatically and to three years for good cause shown) the mark can be registered.<sup>43</sup> If the applicant satisfies this requirement, the initial application will be considered “constructive use” entitling the registrant to nationwide priority from the date of the application.<sup>44</sup> Federal registration of a mark will provide several other advantages, particularly when the trademark owner sues for trademark infringement.<sup>45</sup>

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36. 15 U.S.C. § 1072, Lanham Act § 22 (constructive notice); 15 U.S.C. § 1057, Lanham Act § 7(b) (“A certificate of registration of a mark upon the principal register . . . shall be prima facie evidence of the validity of the registered mark and of the registration of the mark, of the registrant’s ownership of the mark, and of the registrant’s exclusive right to use the registered mark, in commerce on or in connection with the goods or services specified in the certificate, subject to any conditions or limitations stated in the certificate.”).

37. 15 U.S.C. § 1065, Lanham Act § 15.

38. 15 U.S.C. § 1121, Lanham Act § 39.

39. See *Zazu Designs v. L’Oreal, S.A.*, 979 F.2d 499 (7th Cir. 1992) (citing 15 U.S.C. § 1051(a) (modified in 1989)).

40. Pub. L. No. 100-667, 102 Stat. 3935, codified at 15 U.S.C. § 1051.

41. 15 U.S.C. § 1051(b)(1), Lanham Act § 1(b)(1).

42. *Id.* § 1063(b)(2), Lanham Act § 13(b)(2).

43. *Id.* § 1051(d), Lanham Act § 1(d).

44. *Id.* § 1057(c).

45. Advantages from federal registration include: (i) a presumption of validity of the mark and the registrant’s ownership of the mark; 15 U.S.C. § 1057(b), Lanham Act § 7(b); (ii) federal registration functions as constructive notice of a claim of ownership so as to eliminate any claim of good faith adoption and use after the date of registration, 15 U.S.C. § 1072, Lanham Act § 35; (iii) in federal court, profits, damages and costs are recoverable, and treble damages and attorneys fees are available; 15 U.S.C. § 1117, Lanham Act § 22; and (iv) the right to have U.S. Customs exclude infringing goods. 15 U.S.C. § 1124, Lanham Act § 42. See J. Thomas McCarthy, *supra* note 35, at § 19.9.

The duration of a trademark is perpetual as long as it continues to function as a trademark.<sup>46</sup>

A registered trademark or service mark can be assigned “with the good will of the business in which the mark is used, or with that part of the good will of the business connected with the use of and symbolized by the mark.”<sup>47</sup> “Assignments shall be by instruments in writing, duly executed,”<sup>48</sup> and should be notarized.<sup>49</sup> An assignment should include the right to sue for past infringements and to recover any damages for past infringement. The assignment of a federally registered trademark should be registered with the PTO within three months after the date of the assignment, or before subsequent purchase. Otherwise, the assignment “shall be void against any subsequent purchaser for valuable consideration without notice.”<sup>50</sup>

If a trademark or service mark is licensed, it is necessary for the licensor to retain various rights to ensure that the use of the mark, and the quality of the goods or services associated with the mark will be appropriate. Otherwise, the licensee’s use of the mark will confuse consumers, since the mark no longer indicates the same source. An unsupervised license, referred to as a “naked” license, constitutes an abandonment of the trademark. This will terminate the trademark owner’s rights.<sup>51</sup>

#### D. Copyrights

Like patents, copyright protection is authorized by Article I, Section 8, Clause 8 of the U.S. Constitution, which empowers Congress “[T]o promote the progress of science and the useful arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.” “Copyright protection subsists . . . in original works of authorship fixed in any tangible medium of expression.”<sup>52</sup> Copyright protection is available only for the expression of an idea “fixed in a tangible medium,”<sup>53</sup> and is not

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46. *Id.* § 6:31, at 6-61 (“While a copyright is of limited duration, a trademark lasts as long as the trademark significance of the designation is maintained.”).

47. 15 U.S.C. § 1060(a), Lanham Act § 10(a).

48. *Id.*

49. Notarization is prima facie evidence of execution. *Id.*

50. *Id.*

51. 2 J. Thomas McCarthy, *supra* note 35, §§ 17.06, 18.421 and 18.48. See *infra* note 215.

52. 17 U.S.C. § 102(a).

53. A work is “fixed” in a “tangible medium of expression when its embodiment in a copy or phonorecord, by or under the authority of the author, is sufficiently permanent or stable to permit it to be perceived, reproduced, or otherwise communicated for a period of more than transitory duration.” 17 U.S.C. § 101 (definition of the word “fixed”). The statute goes on to state that “A work consisting of

available for an “idea, procedure, process, system, method of operation, concept, principle or discovery.”<sup>54</sup> The owner of a copyright has the exclusive right to: (i) reproduce the work; (ii) prepare derivative works; (iii) distribute copies; (iv) perform the copyrighted work publicly; and (v) display the copyrighted work publicly.<sup>55</sup>

Although registration with the U.S. Copyright Office is not necessary for obtaining copyright protection,<sup>56</sup> it affords various advantages: (i) the creator cannot sue for infringement of a work without first registering the work;<sup>57</sup> (ii) if the registration occurs within three months of publication or before the infringement takes place, the owner may recover attorney fees and statutory damages without proving actual monetary loss (the statutory damages may be within the range of \$200 to \$150,000);<sup>58</sup> and (iii) the certification of a

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sounds, images, or both, that are being transmitted, is ‘fixed’ for purposes of this title if a fixation of the work is being made simultaneously with its transmission.” Id.

54. Id. § 102(b).

55. Id. § 106.

56. Robert P. Merges, Peter S. Menell & Mark A. Lemley, *Intellectual Property in the New Technological Age*, 372 (2001) (“registration of a copyrighted work with the Copyright Office has always been ‘voluntary’”). See also *infra* note 270.

57. 17 U.S.C. § 411(a).

58. Id. §§ 412 (establishing the 3-month rule), 504 (permitting the recovery of actual or statutory damages). In *Feltner v. Columbia Pictures Television*, 523 U.S. 340, 355 (1998), the U.S. Supreme Court held that the Seventh Amendment guarantees a defendant the right to a jury trial on all issues “pertinent to an award of statutory damages under § 504(c) of the Copyright Act, including the amount itself.” In a later proceeding involving the same case, the Ninth Circuit stated:

What the Supreme Court held is that to the extent § 504(c) fails to provide a jury trial right, it violates the Seventh Amendment and is therefore unconstitutional. However, this holding in no way implies that copyright plaintiffs are no longer able to seek statutory damages under the Copyright Act. Indeed, the position urged by [the defendant in this case] is contrary to the express language of the Supreme Court’s decision in this case. As the *Feltner* court stated, “if a party so demands, a jury must determine the actual amount of statutory damages under § 504(c) . . . .” *Feltner*, 523 U.S. at 355. The Court later reaffirmed this point by stating, “[T]he Seventh Amendment provides a right to a jury trial on all issues pertaining to an award of statutory damages under § 504(c) of the Copyright Act, including the amount itself.” Id. This language evinces the Court’s intent to preserve the plaintiff’s ability to seek statutory damages under § 504(c) of the Copyright Act.

*Columbia Pictures Industries, Inc. v. Krypton Broadcasting of Birmingham, Inc.*, 259 F.3d 1186, 1192 (9th Cir. 2001), cert. denied, 2002 U.S. LX 649.

registered work before or within five years after first publication of the work is prima facie evidence of the validity of the copyright.<sup>59</sup>

A copyrighted work created on or after January 1, 1978, is protected for the life of the author plus 70 years after the author's death.<sup>60</sup> However, in the case of a "work for hire"<sup>61</sup> the protection is 95 years from the date of publication or 120 years from the creation of the work, whichever is shorter.<sup>62</sup>

The owner of a copyright may transfer all of his or her rights to the copyright by assignment. An assignment must be in writing and signed by the owner of the rights conveyed or such owner's agent.<sup>63</sup> It is advisable to record the assignment document with the U.S. Copyright Office within one month after its execution in the United States;<sup>64</sup> otherwise, a subsequent bona fide purchaser (who does not have notice of the prior assignment) who records his or her assignment document first will be treated as the owner of the copyright.<sup>65</sup> An assignment document can be valid if it is not notarized, but notarization will be prima facie evidence of the execution of the document.<sup>66</sup>

Also, the owner of a copyright may license the copyright. A license is not technically required to be in writing. However, many states provide that a contract that will not be completely performed within one year must be in writing.<sup>67</sup> Thus, most licenses should be in writing.

#### *E. Computer Software – Over-Lapping IP Protection*

Computer software can be eligible for patent, trade secret, and/or copyright protection. Computer software can function as a literary work, which would suggest copyright protection. As a literary work, computer software is very different from other works, because it is written in source code and object code. Source code is written in special machine readable languages, not intended to be read by any individual. While object code can be read by

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59. 17 U.S.C. § 410(c).

60. Id. § 302(a). Prior to the Sonny Bono Copyright Term Extension Act of 1998, the term was for the life of the author plus 50 years.

61. A "work made for hire" is a work prepared by an employee within the scope of his or her employment, or a work that is: (i) specially ordered or commissioned; (ii) falls within one of the nine specific categories listed in the statute; and (iii) the parties have expressly agreed that the work is to be considered a "work for hire." Id. § 101 (definition of "work made for hire").

62. Id. § 302(c).

63. Id. § 204(a).

64. Id. § 205(d) (if it was executed outside the U.S., it can be filed within two months of the date of execution).

65. Id.

66. Id. § 204(b).

67. 72 Am. Jur. 2d, Statute of Frauds, §§ 10-16 (1974).

individuals, it consists exclusively of “Ones” and “Zeros”. Computer software also can function as a machine, which would suggest trade secret and/or patent protection.<sup>68</sup>

1. *Trade secret protection.*—Prior to 1980, the principal source of IP protection for computer software was trade secret law. Initially, software was not sold separately, and its functions were handled by the computer hardware. When selling a computer system and providing supplemental information, a seller might require the buyer (or anyone else having access to the information) to sign a confidentiality agreement so that the information could continue to be secret, and function as a trade secret.<sup>69</sup> Under trade secret law, the creator of the computer software could enforce his or her rights against an infringer through an injunction, and/or the collection of monetary damages.<sup>70</sup> As discussed above, a major advantage of trade secret protection is that the protection can last for as long as the information remains a secret.<sup>71</sup>

2. *Copyright protection.*—Although copyright law does not protect an “idea, procedure, *process*, system, method of operation, concept, principle or discovery,”<sup>72</sup> amendments to the Copyright Act in 1976 and 1980 clarify that copyright protection is available for computer software. The 1980 Computer

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68. Commentators have stated, “programs are, in fact, machines (entities that bring about useful results, i.e. behavior) that have been constructed in a medium of text (source and object code). The engineering designs embodied in programs could as easily be implemented in hardware as in software, and the user would be unable to distinguish between the two.” Pamela Samuelson, A Manifesto Concerning the Legal Protection of Computer Programs, 94 Colum. L. Rev. 2308, 2315-6 (1994). Section 101 of the Copyright Act defines a “computer program” as “a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result.” 17 U.S.C. § 101.

69. See *Digital General Corp. v. Digital Computer Controls, Inc.*, 297 A.2d 433 (Del. Ch. 1971), *aff’d* 297 A.2d 437 (Del. 1972).

70. UTSA § 2 (injunctive relief) § 3 (damages), reprinted in 14 Uniform Laws Annotated, 449, 455 (1990).

71. See text accompanying *supra* note 27. It also should be remembered that trade secret protection will be lost when others acquire the information by “proper means,” such as independent discovery, or reverse engineering.

72. 17 U.S.C. § 102(b) (emphasis added); See also H.R. Rep. No. 1476, at 57, 94th Cong., 2d Sess. (1976), reprinted in 1976 U.S.C.C.A.N. 5659, 5670 (“Section 102(b) is intended, among other things, to make clear that the expression adopted by the programmer is the copyrightable element in a computer program, and that the actual processes or methods embodied in the program are not within the scope of the copyright law”).



Software Copyright Act<sup>73</sup> defines a “computer program” as “a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result.”<sup>74</sup> Copyright protection is available to “literary works,”<sup>75</sup> and computer programs can be literary works.<sup>76</sup> The legislative history of the 1976 Amendments states “the expression adopted by the programmer is the copyrightable element in a computer program, and . . . the actual processes or methods embodied in the program are not within the scope of the copyright law.”<sup>77</sup> The structure, sequence, and organization of a computer program is protectable by copyright, in addition to the literal computer code.<sup>78</sup> Copyright protection is only available for a work fixed in a tangible medium, and the legislative history provides that the “fixed” requirement will not be met if the concept is “captured momentarily in the memory” of a computer.<sup>79</sup> Screen displays (the output of a computer program) may be protectable as audiovisual or pictorial works.<sup>80</sup>

Although the owner of copyrighted computer software as a general rule has the traditional exclusive rights in the copyrighted work under the Copyright Act,<sup>81</sup> making copies can be an essential part of the ordinary use of a computer program by a purchaser of the software. As a result, the Copyright Act allows the owner of a copy of a computer program to make another copy or adaptation of that computer program if: (i) the copy is created as an essential step in the utilization of the computer program, in conjunction with the machine that is to use the software; (ii) the copy is made for archival purposes and will be destroyed “in the event the continued possession of the computer program should cease to be rightful,”<sup>82</sup> or (iii) the copy is made in connection with the maintenance and/or repair of the machine.<sup>83</sup> This allows a software user to make “backup” copies, and load the program onto the user’s hard-drive.

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73. Pub. L. No. 96-517, 94 Stat. 3028 (1980) (codified at 17 U.S.C. § 101 et seq.).

74. 17 U.S.C. § 101.

75. Id. § 102(a)(1).

76. See *Whelan Associates, Inc. v. Jaslow Dental Laboratory, Inc.*, 797 F.2d 1222, 1233 (3d Cir. 1986), cert. denied, 479 U.S. 1031 (1987) (“[i]t is well . . . established that copyright protection extends to a program’s source and object codes”).

77. H. R. Rep. No. 1476, at 57, 94th Cong., 2d Sess. (1976), reprinted in 1976 U.S.C.C.A.N. 5659, 5670 (referring to Pub. L. No. 94-553, 90 Stat. 2541 (1976) (codified at 17 U.S.C. § 101 et seq.)).

78. *Whelan*, 797 F.2d at 1242-3.

79. H.R. Rep. No. 1476, at 52-53, 94th Cong., 2d Sess. (1976).

80. 17 U.S.C. § 102(a)(5), (6).

81. 17 U.S.C. § 106.

82. 17 U.S.C. § 117(a)(1), (2).

83. 17 U.S.C. § 117(c).

3. *Patent protection.*—Initially, patent protection did not appear to be available for computer software. Computer software was characterized primarily as a mathematical algorithm, and the U.S. Supreme Court denied patent protection, concluding that a mathematical algorithm is not an “invention” under the Patent Act.<sup>84</sup> Although the Court did not directly reverse its position that an algorithm by itself is not patentable, in *Diamond v. Diehr*,<sup>85</sup> the U.S. Supreme Court concluded that if other process steps or physical structures are included in the patent claims, a patent could issue, even though the algorithm might be the only new concept associated with the patent application. In *Diehr*, the applicant characterized the patent as a method for curing synthetic rubber, rather than a method for calculating numbers. This “characterization” approach apparently was adopted by many computer software inventors,<sup>86</sup> and commentators have stated that “by 1994 there were an estimated 14,000 issued software patents in the United States.”<sup>87</sup> In 1996, the PTO issued “Examination Guidelines for Computer-Implemented Inventions,” and by 2000, over 40,000 software patents were in force in the United States, with several thousand more issued every year.<sup>88</sup>

#### F. *Other Examples of Over-Lapping IP Protection*

1. *Designs.*—Computer software is not the only creation eligible for over-lapping IP protection. Designs may qualify for design patent protection, copyright protection, and/or trade dress protection. At one time, courts used a “doctrine of election” under which an item could only enjoy one type of IP protection, so the inventor or author was required to elect.<sup>89</sup> The “doctrine of election” was later rejected in a case<sup>90</sup> involving an application for a watch design patent featuring a caricature of former U.S. Vice President Spiro Agnew. The watch had been the subject of several prior copyright registrations. The Court of Customs and Patent Appeals concluded that the copyright registrations did not foreclose the opportunity for also obtaining design patent protection.<sup>91</sup> The court noted that neither the copyright nor the patent statute made protection

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84. *Gottschalk v. Benson*, 409 U.S. 63 (1972); *Parker v. Flook*, 437 U.S. 584 (1978).

85. 450 U.S. 175, 192 (1981).

86. Pamela Samuelson, *Benson Revisited: The Case Against Patent Protection for Algorithms and Other Computer Program-Related Inventions*, 39 *Emory L. J.* 1025, 1089-90 (1990).

87. Merges, Menell & Lemley, *supra* note 56, 1016 (2001).

88. *Id.* at 1032.

89. See *In re Yardley*, 493 F.2d 1389, 1394 (C.C.P.A. 1974).

90. *In re Yardley*, 493 F.2d 1389 (C.C.P.A. 1974).

91. *Id.* at 1394.

contingent on not having obtained protection under the other statutory scheme, and that each statute set out its own separate degree of protection which is not necessarily equal to the protection afforded by the other statutory scheme. For example, a design patent provides only 14 year protection, whereas a copyright provides protection for a much longer period of time.<sup>92</sup>

Designs also may qualify for both copyright protection and trademark/trade dress protection.<sup>93</sup> The U.S. Supreme Court has stated that, to be copyrightable, a work must possess at least some minimal degree of creativity.<sup>94</sup> As one noted commentator has stated, “Picture[s] and logo designs used as marks are no less copyrightable pictures and designs merely because they appear on labels and in advertisements. However, such pictures and logos must contain the requisite amount of creativity and originality to be protected under copyright law.”<sup>95</sup> Other product designs may qualify for both design patent protection and trademark protection.<sup>96</sup>

2. *Characters.*—Characters used to identify the source of goods or services may be eligible for trademark protection. Furthermore, if the same character reflects the necessary degree of “original authorship,” the representation of the character in a tangible medium may be eligible for copyright protection. A famous example is Walt Disney Company’s character Mickey Mouse.<sup>97</sup> Mickey can help demonstrate an important difference between copyright and trademark protection. If Mickey Mouse was protected by only copyright, after a fixed period of time, Mickey Mouse would enter the public domain and anyone could use Mickey Mouse. The Sonny Bono Copyright Term Extension Act of 1998 extended the duration of copyright protection from the life of the author plus 50 years, to the life of the author plus 70 years.<sup>98</sup> In the case of a work for hire, the duration is now 95 years from the

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92. *Id.* at 1393-95.

93. McCarthy, *supra* note 35, § 6.31, at 6-61 (“Trademark and trade dress protection can extend to certain pictorial or design works which are also subject to copyright”) (citing *Frederick Warne & Co., Inc. v. Book Sales Inc.*, 481 F.Supp. 1191 (S.D.N.Y. 1979)). “No one would seriously argue that copyright protection for Disney characters should be denied merely because they appear on a plethora of goods . . . .” McCarthy, *supra* note 35, § 6.18, at 6-36.

94. *Feist Publications, Inc. v. Rural Telephone Service Co., Inc.*, 499 U.S. 340 (1991); See McCarthy, *supra* note 35, § 6.18, at 6-38.

95. McCarthy, *supra* note 35, § 6.18, at 6-35, 6-36.

96. *Kohler Co. v. Moen, Inc.*, 12 F.3d 632 (7th Cir. 1993).

97. Merges, Menell & Lemley, *supra* note 56, 425 (2001) (discussing duration of copyright protection for Mickey Mouse).

98. 17 U.S.C. § 302(a), (c).

date of publication or 120 years from creation, whichever is shorter.<sup>99</sup> Nevertheless, at some point Mickey Mouse will enter the public domain if only copyright protection is relied upon. However, Walt Disney Company can obtain trademark protection for many Mickey Mouse symbols, and trademark protection can last for as long as the symbol or device continues to be used as a trademark.<sup>100</sup>

### III. NO TAX CONSEQUENCES TO CHARITY FROM ASSIGNMENT OR LICENSING OF IP

Will a charity be obligated to pay income tax on any net income that it generates from the assignment or licensing of IP? Charities generally are exempt from federal income tax.<sup>101</sup> However, a charity is required to pay income tax on its unrelated business taxable income, frequently referred to as the “unrelated business income tax” or “UBIT”.<sup>102</sup> Net income earned by a charity will be subject to UBIT if: (i) the net income is derived from a “trade or business,” (ii) which is regularly conducted, and (iii) which is “unrelated” to the charity’s tax-exempt function.<sup>103</sup> Thus, a threshold question will be whether the net income realized by the charity from the assignment or licensing of the intellectual property will meet all three of these standards. If any one of the three standards is not met, the UBIT does not apply.

For these purposes, “the term ‘trade or business’ includes any activity which is carried on for the production of income from the sale of goods or the performance of services.”<sup>104</sup> Also, the regulations indicate that any activity carried on for the production of income and with a profit motive may be considered a “trade or business.”<sup>105</sup> In determining whether an activity is a trade or business, the courts consider whether the activity is conducted for a profit,

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99. *Id.*

100. McCarthy, *supra* note 35, § 6.18, at 6-38 (“An unauthorized seller of T-shirts imprinted with Disney characters infringes both copyright and trademark rights in characters such as Mickey Mouse”) (citing *Walt Disney Co. v. Powell*, 698 F.Supp. 10 (D.D.C. 1988), *aff’d* in part, and vacated in part, remanded 897 F.2d 565 (D.C. Cir. 1990)).

101. IRC § 501(c)(3). The list of organizations exempt from federal income tax include “corporations and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific . . . or educational . . . purposes.” *Id.*

102. IRC § 511(a)(1).

103. IRC § 513(a).

104. IRC § 513(c).

105. Regs. § 1.513-1(b); Carla Neely Freitag, *Unrelated Business Income Tax*, 874 Tax Mgmt. (BNA), at A-30.

and whether the activity is the type carried on by commercial companies to make a profit.<sup>106</sup>

In determining whether a trade or business is “regularly carried on” for purposes of the UBIT, “regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued”<sup>107</sup> as compared to “comparable commercial activities of [taxable] organizations.”<sup>108</sup> Thus, if an activity is usually conducted year-round by a commercial enterprise, the fact that the charity engages in the activity for only a short period of time would indicate that the charity’s activity should not give rise to UBIT. Evidence that the charity only engages in the activity once a year, such as an annual dance or similar fund-raising activity, would tend to show that the activity should not be considered “regularly carried on.”<sup>109</sup>

In regards to the third test for applying the UBIT – whether the activity is “substantially related” to the organization’s tax-exempt function – the regulations provide that the activity will not generate UBIT if it “contributes importantly” to the organization’s tax-exempt function.<sup>110</sup> In considering whether the activity “contributes importantly,” one factor to consider is the size and extent of the business activity in relation to the nature and extent of the exempt function which the activity purports to serve.<sup>111</sup> If the trade or business is conducted on a scale larger than is reasonably necessary for the performance of the exempt function, the “excess” business activity does not “contribute importantly.”

Even if the income generated by a charity from the exploitation of the intellectual property would be subject to the UBIT under these general rules, there are two exceptions that could allow the charity to avoid paying income tax on amounts derived from the exploitation of intellectual property. First, section 512(b)(2) excludes “all royalties . . . whether measured by production or by gross or taxable income from the property . . . .”<sup>112</sup> Thus, if the charity will receive royalties as a result of licensing intellectual property to a third party, those royalties should not be subject to the UBIT. The royalty exception

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106. *United States v. American Bar Endowment*, 477 U.S. 105, 111 (1986) (income derived from the promotion or sponsorship of a group insurance program for members by an organization formed to advance the legal profession and the administration of justice is considered unrelated business taxable income).

107. Regs. § 1.513-1(c)(1).

108. *Id.*

109. See Regs. § 1.513-1(c)(2)(iii).

110. *Id.* § 1.513-1(d)(2).

111. *Id.* § 1.513-1(d)(3).

112. *Id.* § 1.512(b)-1(b).

is similar to other exclusions for passive income.<sup>113</sup> However, if the charity provides substantial services in connection with the activity, the payments may be characterized as a fee for services, subject to the UBIT, rather than as a passive royalty.<sup>114</sup> Second, section 512(b)(5) excludes from the UBIT “all gains or losses from the sale, exchange, or other disposition of property other than . . . property held primarily for sale to customers in the ordinary course of the trade or business.”<sup>115</sup> Thus, as long as the charity is not in the business of regularly assigning intellectual property to “customers,” the charity’s net income from the assignment of intellectual property should not be subject to the UBIT.

#### A. Patents

In Revenue Ruling 76-297,<sup>116</sup> the IRS considered a charity formed to promote scientific investigation and research at a university. The organization accepts inventions of individuals associated with the university. The inventor “executes an irrevocable assignment of both his [or her] legal and *beneficial* rights in the invention to the organization which in return agrees to pay a specified percentage of royalties subsequently received from licensees.”<sup>117</sup> The IRS concluded that under the facts of the particular arrangement the amounts received by the organization were royalties excluded from the UBIT under section 512(b)(2). The IRS distinguished a prior ruling<sup>118</sup> in which the charity had only bare legal title to the patent and the amounts it received were actually payments for services rendered.

#### B. Trademarks

In Revenue Ruling 81-178,<sup>119</sup> the IRS considered a tax-exempt labor union for professional athletes<sup>120</sup> which solicits and negotiates licensing

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113 For example, interest, dividends, and amounts received from annuities also are excluded from the UBIT. IRC § 512(b).

114. *Fraternal Order of Police v. Commissioner*, 833 F.2d 717, 723-4 (7th Cir. 1987), aff’g 87 T.C. 747 (1986); Rev. Rul. 73-193, 1973-1 C.B. 262; See Freitag, *supra* note 105, at A-87.

115. IRC § 512(b)(5)(B).

116. 1976-2 C.B. 178.

117. *Id.* (emphasis added).

118. Rev. Rul. 73-193, 1973-1 C.B. 262.

119. 1981-2 C.B. 135.

120. Although a labor organization is classified as tax-exempt under IRC § 501(c)(5), rather than IRC § 501(c)(3) which is the classification for charities eligible to receive tax deductible contributions under IRC § 170, the analysis for UBIT purposes is the same.

agreements with various businesses which desire to use “the organization’s trademarks, trade names, service marks, copyrights and members’ names, photographs, likenesses and facsimile signatures.”<sup>121</sup> The IRS stated that, “[p]ayments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinary classified as royalties for federal tax purposes.”<sup>122</sup> The IRS concluded that the royalties received by the organization would not be subject to the UBIT because of the royalty exclusion of section 512(b)(2), even though the organization retained the right to approve the quality and style of the licensed products.

The Tax Court has held that the income from an “affinity card program” is not subject to the UBIT.<sup>123</sup> In an affinity card program, the charity encourages its members (through the use of its member list) to use credit cards issued by a particular financial institution bearing the trademark and/or trade name of the charity. The Tax Court held that the income received by the charity qualifies for the royalty exception of section 512(b)(2) provided that the charity’s activities are kept to a minimum.<sup>124</sup>

### C. Copyrights

In Revenue Ruling 69-430,<sup>125</sup> the charity owns the publication rights to a book. The Ruling states that if the organization transfers its publication rights to a commercial publisher in return for royalties, the royalty income will not be subject to the UBIT.<sup>126</sup> However, if the organization had actively exploited the

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121. 1981-2 C.B. at 135. This ruling supports the conclusion that a charity’s income from the exploitation of an individual’s “right to publicity” will not be subject to the UBIT.

122. *Id.* at 136.

123. *Sierra Club, Inc. v. Commissioner*, 103 T.C. 307 (1994) *aff’d* in part, reversed in part, and remanded 86 F.3d 1526 (9th Cir. 1996); on remand 77 T.C. Memo (CCH) 1569 (1999); *Oregon State University Alumni Ass’n v. Commission*, 71 T.C. Memo (CCH) 1935 (1996), *aff’d* 193 F.3d 1098 (9th Cir. 1999).

124. *Oregon State University Alumni Ass’n*, 71 T.C. Memo (CCH) 1935, 1939-40 (1996) (emphasizing that the services provided by the charity were “de minimis”); See also *Common Cause v. Commissioner*, 112 T.C. 332 (1999) (amounts received from the rental of a charity’s mailing list qualified as royalties, and as a result, the amounts were not subject to the UBIT); *Planned Parenthood Fed’n of Am., Inc. v. Commissioner*, 77 T.C. Memo (CCH) 2227 (1999) (indicating that all amounts received may qualify as “royalties” although the organization provides certain services in connection with exploiting its mailing list).

125. 1969-2 C.B. 129.

126. *Id.* at 130.

book itself in a commercial manner, rather than hiring the commercial publisher, the income received would have been taxable under the UBIT.<sup>127</sup>

#### IV. RESTRICTIONS ON CLAIMING A CHARITABLE CONTRIBUTION DEDUCTION

Congress has allowed an income tax deduction for contributions to charitable organizations since 1917.<sup>128</sup> In general, a charitable contribution deduction is available for the fair market value of the property contributed.<sup>129</sup> From this straight forward beginning, the taxpayer attempting to claim an income tax deduction for a charitable contribution is faced with numerous restrictions and limitations.

##### A. Itemized Deduction

A charitable contribution deduction is an itemized deduction.<sup>130</sup> As a result, the taxpayer may only deduct the contribution if he or she is eligible to itemize. To itemize, a taxpayer's total itemized deductions must exceed the "standard deduction amount."<sup>131</sup>

##### B. 3% and 80% Restrictions

If the taxpayer's adjusted gross income is above a certain threshold amount, the taxpayer's otherwise allowable itemized deductions will be reduced by the lesser of: (i) 3% of the excess of the taxpayer's adjusted gross

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127. Id.

128. Weidenbeck, Charitable Contributions: A Policy Perspective, 50 Mo. L. Rev. 85, 87 n. 11 (1985). IRC § 170(a)(1) ("There shall be allowed as a deduction any charitable contribution . . . payment of which is made within the taxable year.").

129. Regs. § 1.170A-1(c)(1). In general, the deduction is based on the fair market value of the property even if the taxpayer's basis is greater than the property's fair market value. For example, if the taxpayer purchases the property for \$100 and donates the property when its value is \$50, the charitable deduction will only be \$50.

130. See IRC § 63(d), which provides that any deduction, other than the deduction allowed under IRC § 151 (the personal exemption) and the deductions allowed in calculating adjusted gross income under IRC § 62, will be considered an "itemized deduction." Charitable contributions are not listed in §§ 62 or 151, and therefore are itemized deductions.

131. The standard deduction is an amount which the taxpayer is entitled to deduct each year even if his or her itemized deductions are less than the "standard deduction." IRC § 63(c). The standard deductions for 2002 are: \$7,850 for joint filers and surviving spouses; \$6,900 for heads of household; \$4,700 for single individuals; and \$3,925 for married persons filing separately.



income over the applicable threshold amount; or (ii) 80% of the amount of the itemized deductions otherwise allowable.<sup>132</sup> For 2002, the applicable threshold amount is \$137,300 (\$68,650 for married individuals filing separately). Medical expenses, investment interest expenses, and casualty or theft losses are not subject to the 3%/80% reduction rule.<sup>133</sup> As a result, the primary itemized deductions subject to the 3%/80% reduction rule are: (i) state and local income taxes, (ii) real and personal property taxes; (iii) home mortgage interest; (iv) charitable contributions; and (v) miscellaneous itemized deductions subject to the 2% limitation of section 67(a) (which includes unreimbursed employee expenses, investment expenses, and tax preparation fees). For a higher income taxpayer, the 3%/80% reduction rule can significantly reduce the value of a charitable deduction, particularly if the taxpayer lives in a state that does not impose a state income tax.<sup>134</sup>

Example #3: Both Texas Hank and California Cal are single individuals with adjusted gross income of \$1 million in 2002. They both rent their homes, so they pay no real estate taxes and claim no home mortgage interest deductions. Their itemized deductions subject to the 3%/80% reduction rule are as follows:

	<u>Texas Hank</u>	<u>California Cal</u>
1. State & Local Income Tax	-0-	\$85,000*
2. Real & Personal Property Tax	\$2,000	\$2,000
3. Home Mortgage Interest	-0-	-0-
4. Charitable Gifts	\$30,000	\$30,000
5. Misc. Itemized Deductions	-0-	-0-
Total Deductions	\$32,000	\$117,000
Reduction Amount	(\$25,600)**	(\$25,881)***
Permitted Itemized Deductions	\$6,400	\$91,119

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132. IRC § 68(a).

133. Id. § 68(c).

134. State income taxes are allowed as an itemized deduction. IRC § 164(a)(3). Taxpayers who pay no State income tax may have a small amount of itemized deductions. The States that do not impose an income tax are: Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. New Hampshire and Tennessee impose an income tax on limited types of income, such as interest, dividends, and capital gains. H.R. Rep. No. 389, 104th Cong., 2d Sess., reprinted in 1995 U.S.C.C.A.N. 1006, 1008, n.6 (Report of Judiciary Committee on Public Law 104-95, State Income Taxation of Pension Income).

\* An approximation based on California income tax of \$1,876.02 + 9.3% of taxable income above \$51,350. See State Tax Guide – All States (CCH), ¶ 905, p. 1328.

\*\* The reduction factor under section 68(a) for Texas Hank is the lesser of: (i) 80% of the otherwise allowable deduction (\$32,000 x 80% = \$25,600), or (ii) 3% of his adjusted gross income in excess of the threshold amount: (\$1 million - \$137,300 = \$862,700) x 3% = \$25,881.

\*\*\* The reduction factor under section 68(a) for California Cal is the lesser of: (i) 80% of the otherwise allowable deductions (\$117,000 x 80% = \$93,600), or (ii) 3% of his adjusted gross income in excess of the threshold amount: (\$1 million - \$137,300 = \$862,700) x 3% = \$25,881.

In this example, Texas Hank is able to deduct only 20% of his charitable contribution (a \$6,000 deduction on a \$30,000 contribution). In contrast, California Cal can deduct the full \$30,000. Cal is obligated to pay the California state income tax in any event, and the reduction amount under section 68(a) is based on Cal's adjusted gross income. In effect, the reduction factor only reduces Cal's ability to deduct the California state income tax.

### C. 50%, 30% and 20% Limitations

A taxpayer cannot claim charitable contribution deductions in excess of a certain percentage of his or her "contribution base." The "contribution base" is simply the taxpayer's adjusted gross income without regard to any net operating loss carryback under section 172.<sup>135</sup> Cash contributions to public charities can be deducted up to 50% of the taxpayer's "contribution base."<sup>136</sup> Non-cash contributions can be deducted to the extent of 30% of the taxpayer's "contribution base."<sup>137</sup> If the gift is made to a private foundation,<sup>138</sup> rather than to a public charity, the percentage limitations are 30% and 20% rather than

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135. IRC § 170(b)(1)(F).

136. *Id.* § 170(b)(1)(A).

137. *Id.* § 170(b)(1)(B)(i).

138. A "public charity" is an organization described in IRC § 509(a)(1), (2), or (3). A public charity generally receives at least a certain percentage of its "support" as contributions from the general public, from grants from the government or from other public charities, or from the performance of services related to its charitable purpose. In contrast, a private foundation is an organization described in IRC § 501(c)(3), which fails to meet the support tests of IRC § 509(a)(1), (2) or (3). A private foundation frequently receives the great majority of its funds from a single individual or a single family group.

50% and 30%.<sup>139</sup> If the taxpayer's contribution deductions are restricted by these percentage limitations, the excess amount may be carried over and used in the next five years, subject to the applicable percentage limitations in each of those years.<sup>140</sup> If a contribution cannot be deducted within that five year period, it will be lost.

*D. Reduction of Charitable Deduction for Any Gain that Would Be Taxed as Ordinary Income*

In calculating the amount of the charitable deduction in the case of a non-cash contribution, it is necessary to determine whether a hypothetical sale of the donated property would generate ordinary income or long-term capital gain (for these purposes, a short-term capital gain is treated in the same manner as ordinary income).<sup>141</sup> If a hypothetical sale of the donated property would generate ordinary income, the taxpayer's otherwise allowable charitable contribution deduction will be reduced by the amount of the gain.<sup>142</sup> As discussed later in this Article, this rule is extremely important in the case of gifts of intellectual property because the gain from the sale of a copyright is always considered ordinary income.<sup>143</sup>

*E. Reduction of Charitable Deduction for Gain that Would Be Taxed as Long-Term Capital Gain on a Donation of Tangible Personal Property for an "Unrelated Use"*

If tangible personal property (that would generate a long-term capital gain on a hypothetical sale of the property) is contributed to charity, it is necessary to determine whether the property will be used in a manner that is "related" to the charity's tax-exempt function. If the tangible personal property will not meet the "related use" test, then the amount of the charitable contribution deduction must be reduced by the amount of any gain that would

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139. Id. § 170(b)(1)(D) and (E).

140. Id. § 170(b)(1)(B) (flush language).

141. A "capital gain" is a gain generated from the sale or exchange of a capital asset, as defined in IRC § 1221(a). A capital gain will be "long term" if the taxpayer has held the property for more than one year before the sale or exchange; the capital gain will be "short term" if the taxpayer has held the property for one year or less before the sale or exchange. Id. § 1222(1), (3).

142. Id. § 170(e)(1)(A).

143. Id. § 1221(a)(3); See *infra* notes 216-220 and accompanying text.

be recognized on a hypothetical sale of the donated property (even if the gain on a hypothetical sale would be taxed as long-term capital gain).<sup>144</sup>

As has been discussed by many commentators, this is an extremely important rule for an art collector who contributes a work of art to charity.<sup>145</sup> If the artwork is donated to a museum that will display the art in its galleries, or to a university that will use the work in an art appreciation class, or to another entity that will use the art in a manner related to the charity's exempt function, the collector will be able to deduct the full fair market value of the art as a charitable contribution deduction, including the appreciation in value of the art since it was purchased by the collector.<sup>146</sup> In contrast, if the collector contributes the artwork to a charity that will sell the artwork (even if the charity will use the money for worthwhile charitable causes), the collector's charitable deduction will be reduced by the amount of gain that he or she would have recognized on a hypothetical sale of the artwork. In effect, the art collector's charitable contribution deduction will be limited to the amount the collector paid for the art.

#### F. *The Partial Interest Rule*

A taxpayer generally will not be allowed a charitable contribution deduction for a gift of a partial interest in property.<sup>147</sup> In other words, if a taxpayer donates certain rights in property to charity, and retains other rights, he or she will not be allowed any charitable contribution deduction. For example, if a taxpayer donates a copyrighted work, but does not donate the copyright, no charitable income tax deduction will be allowed.<sup>148</sup> Thus, in

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144. *Id.* § 170(e)(1)(B). The same reduction rule applies on a contribution to a private foundation, except that the reduction is made for the amount of appreciation regardless of whether the private foundation will use the donated property in a manner related to its tax-exempt purpose. *Id.* § 170(e)(1)(B)(ii).

145. Robert Anthoine, *Deductions for Charitable Contributions of Appreciated Property – The Art World*, 35 *Tax L. Rev.* 239 (1980); Douglas J. Bell, *Changing I.R.C. § 170(e)(1)(A): For Art's Sake*, 37 *Case W. Res. L. Rev.* 536 (1987).

146. IRC § 170(e)(1)(B)(i); Anthoine, *supra* note 145, at 244-246.

147. IRC § 170(f)(3). The exceptions to this rule include: (i) gifts of a remainder interest in a personal residence or farm, (ii) a contribution of an undivided portion of the taxpayer's entire interest in property, and (iii) a qualified conservation contribution. *Id.* § 170(f)(3)(B). Other exceptions include qualifying charitable gift annuities and qualifying charitable remainder trusts. *Id.* § 170(f)(2).

148. Arthur Anderson, *Tax Economics of Charitable Giving*, 158 (12th ed. 1995) ("A work of art and its copyright generally have been considered to be two interests in the same property"). In 1981, Congress passed a limited exception for estate tax purposes. Under IRC § 2055(e)(4), the copyright and the tangible personal property will be treated as items of separate property for purposes of the estate tax charitable deduction.

planning a charitable contribution, it is essential that the taxpayer donate his or her entire interest in the property (assuming that he or she wishes to claim a charitable deduction). The partial interest rule will not apply if the taxpayer donates an “undivided” interest in the property to charity,<sup>149</sup> and the partial interest will not apply if the taxpayer donates his or her entire interest in the property to the charity.

## V. CHARITABLE GIFTS OF IP UNDER CURRENT LAW

### A. Patents and Charitable Giving

The nirvana of charitable giving tax treatment is enjoyed by the creative genius whose work results in a patent. An individual donating a patent to charity: (i) will be entitled to a charitable contribution deduction equal to the full fair market value of the appreciated property; and (ii) is free to select the public charity<sup>150</sup> that will receive the gift without regard to whether the charity can use the patent in a manner related to its charitable purpose.

1. *Availability of a Full Fair Market Value Deduction on the Donation of a Patent.*—An individual donating a patent to charity will be eligible to claim a charitable contribution deduction for the full fair market value of the patent.<sup>151</sup> This wonderful result occurs because section 1235(a) provides that the gain

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149. IRC § 170(f)(3)(B)(ii).

150. In order to claim a charitable contribution deduction for the full fair market value, the donation must be made to a “public charity” (as described in IRC § 509(a)(1), (2) or (3)) rather than to a “private foundation.” See supra note 138 for a description of a “public charity” and a “private foundation.” In the case of a donation to a private foundation (other than an “operating” private foundation), the deduction will be reduced by any gain that would have been long-term capital gain on a hypothetical sale of the donated property. IRC § 170(e)(1)(B)(ii) (a popular exception to this general rule is for gifts of appreciated marketable securities to private foundations).

151. The legislative history of the Revenue Act of 1950 provides that this favorable treatment is available to the inventor because “the desirability of fostering the work of inventors outweighs the small amount of additional revenue which might be obtained” if the gains from the sale of inventions, patents, and designs could not qualify for long-term capital gain treatment. S. Rep. No. 2375, 81st Cong., 2d Sess. 44 (1950), reprinted in 1950-2 C.B. at 515 (quoted in, Changing I.R.C. § 170(e)(1)(A): For Art’s Sake, 37 Case W. Res. L. Rev. 536, 559, n.157-158 (1987)). Id. (“[t]he inventions of amateur inventors are afforded capital asset treatment, as are the patents secured by both professionals and amateurs”). See also Suresh T. Advani, Characterizing the “New” Transfers of Intellectual Property, Taxes, 211, 213 (March 2001) (“[c]ongress apparently considered creators of literary and artistic works less important to the welfare of the Nation”).

from the sale of a patent will be taxed as a long-term capital gain.<sup>152</sup> As discussed earlier,<sup>153</sup> if the gain on a hypothetical sale of the donated asset would be taxed as ordinary income (or short-term capital gain), the amount of the deduction on a charitable donation of that property would be reduced by the amount of that gain.<sup>154</sup> Since a gain on the hypothetical sale of a patent would be taxed as long-term capital gain, no reduction in the charitable contribution deduction for the appreciation in value is necessary. Moreover, it is not even necessary for the patent or the patent application to be in existence for section 1235 to apply. Favorable tax treatment is available for the transfer of an inchoate right to obtain a patent (as long as the subject matter is patentable).<sup>155</sup>

2. *Patents and the Partial Interest Rule.*—As discussed above, as a general rule, a taxpayer who donates only a “partial interest” in property is

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152. IRC § 1235(a) provides in part that “a *transfer* (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any *holder* shall be considered the sale or exchange of a capital asset held for more than 1 year . . . .” (emphasis added). A “holder” is an individual who either created the property, or who acquired his or her interest before the invention was “reduced to practice” in exchange for consideration paid to the creator. IRC § 1235(b). Section 1235 was enacted to assist and encourage individual inventors (by providing favorable tax treatment on the sale of a patent). See S. Rep. No. 1622, 83d Cong., 2d Sess. 439 (1954) (Section 1235 was enacted “to provide an incentive to inventors to contribute to the welfare of the Nation”), reprinted in Charles Edward Falk, *Tax Planning for the Development and Licensing of Patents and Know-How*, 557 *Tax Mgmt. (BNA) B-301*; See also Advani, *supra* note 151, at 212. Section 1235 makes no distinction between a “professional” inventor (who might be said to hold his inventions as inventory), and the more casual inventor (who might be described as an upstairs attic inventor). Falk, *supra* at A-22. Thus, inventors (and their patents) have been twice blessed by Congress – in 1950, Congress chose not to include patents in the list of property that cannot qualify for capital gain treatment under IRC § 1221(a)(3), see *supra* note 151; and in 1954, Congress enacted § 1235.

153. See *supra* notes 141-143 and accompanying text.

154. IRC § 170(e)(1)(A) (“[t]he amount of any charitable contribution of property otherwise taken into account . . . shall be reduced by . . . the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value . . .”).

155. Regs. § 1.1235-2(a); S. Rep. No. 1622, 83rd Cong., 2d Sess. 439 (1954), reprinted in Falk, *supra* note 152, at B-301; *Id.* at A-10 (“Section 1235 can apply if the product is patentable”); *Gilson v. Commissioner*, 48 T.C. Memo (CCH) 922, 926 (1984) (“[i]t is largely irrelevant that out of the 82 separate contracts, only one or two of [the taxpayer’s] designs were actually patented . . . . For a transfer to come within section 1235, it is sufficient that the taxpayer transfer all substantial rights to a patentable product . . .”).

prohibited from claiming any charitable contribution deduction.<sup>156</sup> However, an individual can contribute an “undivided” fractional interest in a patent and claim a deduction for the value of the portion contributed even though the donor has retained for himself or herself valuable rights under the patent.<sup>157</sup> For example, the donor can contribute a one-fourth interest in the patent to a charity, retain the remaining three-fourth interest, and claim a charitable deduction for the one-fourth interest donated. In a 1958 ruling, the IRS concluded that a deduction would be available if the donor, before making the charitable contribution, granted his wholly-owned corporation a license to practice the patent and sell the resulting products; subsequent developments may prevent a deduction in that situation today.<sup>158</sup>

3. *Donation of a Patent Compared to a Donation of Services.*—The tax consequences for the individual who donates a patent to charity are far more favorable than for the taxpayer who merely donates his or her services to charity. The inventor of a patent will not be required to recognize taxable income on the donation of his or her patent, will not be taxed on any royalties or other income earned by the charity from the exploitation of the patent,<sup>159</sup> and

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156. IRC § 170(f)(3). See *supra* notes 147-149 and accompanying text.

157. Section 1235 applies to a transfer of “all substantial rights to a patent, or an *undivided interest* therein . . .” (emphasis added) “[A]ll substantial rights” will not be transferred if the transfer is limited in duration to a period less than the remaining life of the patent; the rights granted are limited to particular fields of use, or the grant covers less than all the claims covered by the patent. Regs. § 1.1235-2(b)(1)(ii) – (iv). In addition, “all substantial rights” will not have been transferred if the grant of patent rights is limited to a particular geographic area within the country issuing the patent. *Id.* § 1.1235-2(b)(1)(i).

158. In Rev. Rul. 58-260, 1958-1 C.B. 126, the taxpayer was the inventor and owner of a patented process. The taxpayer granted to a corporation (wholly-owned by the taxpayer and his wife) a nonexclusive right to practice the process and sell the product. Thereafter, the taxpayer contributed a one-fourth interest in the patent to charity. The IRS concluded that the taxpayer would be entitled to a charitable contribution deduction for the fair market value of the one-fourth interest. In 1969, Congress enacted the partial interest rule of IRC § 170(f)(3), Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(a)(1), and although a deduction is permitted if the taxpayer contributes his or her entire interest in the property, no deduction is allowed if the property was divided for the purpose of circumventing the partial interest rule. Regs. § 1.170A-7(a)(2)(i).

159. *Id.* Nevertheless, if a donor merely assigns a right to receive royalties to a charity (rather than assigning the patent or an undivided interest in the patent), the donor will be required to include the royalty amount in his or her gross income, and will be eligible for a charitable contribution deduction for the amount of the royalties actually paid to charity. Barbara L. Kirschten & Carla Neeley Freitag, *Charitable Contributions: Income Tax Aspects*, 521 *Tax Mgmt. (BNA)* 11. This would put the

will be entitled to a charitable deduction for the full fair market value of the patent. While a taxpayer who provides services to charity will not be required to include the value of those services in his or her income,<sup>160</sup> those who provide services to charity are not entitled to a charitable deduction for the value of the services.<sup>161</sup> In an early case the IRS argued that an inventor should not be entitled to a charitable contribution deduction because the donation of the invention was similar to a donation of services, but the Tax Court rejected that argument, stating that the inventor's services are "*coalesced* in the resultant property interests."<sup>162</sup>

4. *Potential Pitfalls for the Donor of a Patent.*—Not surprisingly, there are a few potential traps for the inventor making a charitable gift. Section 1235 (which in effect permits the donor to claim a full fair market value charitable deduction) does not apply to a corporation or other entity.<sup>163</sup> Also, section 1235

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inventor in a potentially dangerous situation – he or she would be taxed on the full amount of the royalties received by the charity, but his or her charitable deduction may be limited by the 50% rule of IRC § 170(b)(1), and/or the 3%/80% rule of IRC § 68(a). Under the 50% rule, a taxpayer can only claim charitable contribution deductions for the year (for cash gifts to public charities) up to 50% of his or her modified adjusted gross income (any excess can be carried forward for five years). Under IRC § 68(a), a taxpayer with taxable income in excess of the threshold amount (in 2002, \$137,300, or \$68,650 for married individuals filing separately) will have his or her itemized deductions (including charitable contributions) reduced by the lesser of: (i) 3% of his or her adjusted gross income in excess of the threshold amount; or (ii) 80% of the itemized deductions otherwise allowable for the year. See text accompanying supra notes 132-140. Thus, the inventor might be taxed on all the royalty income, but the amount of his or her charitable deduction may be limited.

160. For example, an attorney who provides pro bono legal services to his or her favorite charity is not required to include in his or her taxable income the fair value of his or her services. This is an obvious result in the case of a "cash basis taxpayer" because the taxpayer never has actual or constructive receipt of any fees for the services provided to charity. Regs. § 1.446-1(c)(1)(i).

161. Regs. § 1.170A-1(g); See *Levine v. Commissioner*, 54 T.C. Memo (CCH) 209; T.C. Memo (RIA) ¶ 87,413 (1987) (attorney was not entitled to claim a charitable contribution deduction for the value of legal services provided to charity; the government had stipulated that the value of the attorney's services for the year was \$7,000).

162. *Cupler v. Commissioner*, 64 T.C. 946, 954 (1975) (emphasis added). However, as one commentator has stated, "[t]he fact that intellectual property is the fruit of individual effort has not been lost on the tax law." Advani, supra note 151, at 219.

163. IRC § 1235(b); Rev. Rul. 76-414, 1976-2 C.B. 248; See Falk, supra note 152, at A-17 (stating that neither a partnership, trust, estate or a corporation can use section 1235). Although a partnership cannot be a "holder" under section 1235, any individual member of the partnership may qualify under IRC § 1235(a) as to his or her



only applies when there has been a transfer of all substantial rights in a patent, or when there has been a transfer of an undivided interest in a patent. As a result, section 1235 would not be available if the donor merely grants the charity a license to use the patent (which is limited geographically, or covers some but not all of the patent claims or uses).<sup>164</sup> When section 1235 does not apply, the tax consequences of the arrangement need to be analyzed under the tax rules that otherwise apply to a sale or exchange of property.<sup>165</sup>

Also, the IRS may dispute the taxpayer's valuation of the donated patent.<sup>166</sup> In valuing a patent, the IRS has successfully argued that patent validity, technological feasibility, and difficulty of enforcement should be considered.<sup>167</sup> The potential for disagreement is highlighted in the case of *Smith v. Commissioner*, in which the taxpayer (a patent attorney for Hewlett-Packard) claimed that the value of his donated patent was over \$200,000. The IRS and the Tax Court concluded that the value of the patent was \$3,500.<sup>168</sup>

In addition, if the donor merely gives the prototype, machine or product that is produced from the patentable invention to the charity, but fails to actually assign all or an undivided interest in the patent (or the potential patent) to the charity, a charitable deduction will be allowed for only the fair market value of the prototype, machine, or product, which undoubtedly will be much lower than the fair market value of the object and the patent together. The dangers of this potential pitfall were illustrated by a rather unfortunate taxpayer (John A. Cupler II) who described himself as a "mad scientist."<sup>169</sup> The Tax Court described Mr. Cupler as an "extraordinarily gifted and dedicated engineer" who had produced at least 50 patents on inventions in the field of

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share of the invention owned by the partnership. Regs. § 1.1235-2(d)(2). This could be very important if there are several individuals who operate as a partnership with respect to a particular patentable invention.

164. Regs. § 1.1235-2(b)(1) (ii)-(iv); S. Rep. No. 1622, 83d Cong., 2d Sess. 438 (1954), reprinted in Falk, *supra* note 152, at B-301.

165. Rev. Rul. 69-482, 1969-2 C.B. 164 (concluding that "sale or exchange" treatment may be available even if section 1235 does not apply). The proper tax treatment for those who fail to qualify under section 1235 can be subject to considerable debate. See Falk, *supra* note 152, at A-22 to A-27. The tax rules that generally apply to a sale or exchange of property are described below in regards to a sale of a trade secret. See text accompanying *infra* notes 179-206.

166. *Smith v. Commissioner*, 41 T.C. Memo (CCH) 1427; T.C. Memo (RIA) ¶ 81,219 (1981).

167. *Id.* For charitable contribution purposes, the "fair market value" of donated property generally is the price at which a willing buyer and a willing seller, neither under any particular compulsion to buy or sell, would reach an agreement on the sale of the property. Regs. § 1.170A-1(c)(1).

168. *Smith*, 41 T.C.M. (CCH) at 1427.

169. *Cupler v. Commissioner*, 64 T.C. 946, 954, n.4 (1970).

precision drilling equipment, and “made a significant contribution to medical knowledge” in preparing an advanced (for that time) cataract removal machine, and a heart-lung machine. Mr. Cupler donated both machines to charity. In claiming his charitable contribution deductions, Mr. Cupler valued his donations at \$144,500 and \$149,990. Unfortunately, the IRS and the Tax Court noticed that Mr. Cupler had failed to assign his (potential) patent rights in the inventions to charity, and concluded that he was entitled to charitable contribution deductions of only \$10,000 and \$15,000, respectively.

5. *The “Related Use” Restriction Does Not Apply.*—Since a patent is intangible property, the “related use” restriction<sup>170</sup> does not apply to a charitable donation of a patent. As discussed above, the “related use” restriction provides that to claim a deduction equal to the fair market value of *tangible* property, the property must be donated to a charity which will use the property in a manner related to its charitable purpose (for example, a museum may display a donated painting, thereby employing the painting in a “related” use).<sup>171</sup> Thus, the individual donating a patent is free to donate the patent to his or her favorite public charity and receive the maximum tax benefit, regardless of whether the receiving charity retains the property and uses the property in carrying out its exempt purpose. For example, the donor can contribute the patent to a church which can immediately sell the patent,<sup>172</sup> and the church could use the proceeds to help the poor. Alternatively, the church might license the patent and receive royalty income that would not be subject to the UBIT.<sup>173</sup>

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170. IRC § 170(e)(1)(B). See supra notes 144-146 and accompanying text for a general discussion of the “related use” restriction.

171. Under IRC § 170(e)(1)(B)(i) if the use by the donee of the tangible property is unrelated to the organization’s charitable purposes or functions, the amount of the deduction will be reduced by any long-term capital gain that would have resulted from a sale of the property. See supra notes 144-146 and accompanying text.

172. Initially it might appear that the IRS or a court could use the “step transaction” or “substance over form” doctrines to conclude that in reality the inventor is selling the patent, and then transferring the sale proceeds to the charity. This tax characterization would not be as favorable to the inventor because he or she would pay tax on the gain from the sale. However, in the context of charitable gifts of appreciated property, the courts have traditionally held that the “step transaction” and/or “substance over form” doctrines will not apply as long as the charity is not obligated to sell the property at the time of the donation. See *Palmer v. Commissioner*, 62 T.C. 684 (1974), aff’d 523 F.2d 1308 (8th Cir. 1975), acq. Rev. Rul. 78-197, 1978-1 C.B. 83; *Grove v. Commissioner*, 490 F.2d 241 (2d Cir. 1973); *Carrington v. United States*, 476 F.2d 704 (5th Cir. 1973).

173. IRC § 512(b)(2). See supra notes 116-118 and accompanying text.

## B. Trade Secrets and Charitable Giving

While the creative genius who gives birth to a trade secret will encounter a more difficult and circuitous route, the path to charitable giving tax nirvana can be attained in the right circumstances — the donor can be entitled to a charitable contribution deduction equal to the full fair market value of the property, even if the charity will not use the property in a manner related to its charitable purpose.

1. *Trade Secret Protection Compared to Patent Protection.*—Frequently, information can be eligible for trade secret protection, but cannot be patented. In some instances, even if patent protection is available, the inventor may prefer trade secret protection over patent protection.<sup>174</sup> As described above, generally any information may qualify for trade secret protection if it: (i) has independent economic value; (ii) is not generally known and is not readily ascertainable by proper means; and (iii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.<sup>175</sup>

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174. For an example in which the inventor preferred trade secret protection over patent protection, see *Kewanee Oil v. Bicon Corp.*, 416 U.S. 470 (1974), discussed at *supra* note 25. An inventor may prefer trade secret protection because patent protection is for a limited duration, but trade secret protection can last for as long as the information remains a secret. The inventor with a patent will have the exclusive right to exclude others from using the innovation for only a fixed period of time – generally 20 years from the date of filing the application. 35 U.S.C. § 154(a)(2). In contrast, the protection afforded a trade secret is potentially perpetual, although it will end once the information is no longer “secret.” For example, the formula for producing a soft drink might be patentable, but once the patent is issued (or if the inventor seeks patent protection beyond the United States, 18 months after the application is filed, 35 U.S.C. § 122(b)), the formula will be disclosed to the public, and the inventor’s exclusive rights will end 20 years after the patent application is filed. 35 U.S.C. § 154(a)(2) (unless the PTO has delayed the consideration of the application). In contrast, if no patent application is filed and instead the soft drink inventor relies upon trade secret protection, the inventor can enjoy the exclusive right to exploit the soft drink for as long as it remains a secret. In addition, if the trade secret inventor and a licensee agree that the licensee shall make payments for a fixed period of time, the trade secret inventor may be able to collect royalties under the contract long after the information is no longer secret. See *Warner-Lambert Pharmaceutical Co. v. Reynolds, Inc.*, 178 F.Supp. 655 (S.D.N.Y. 1959) (involving the formula for Listerine®).

175. See *supra* notes 22-25 and accompanying text. Uniform Trade Secrets Act § 1(4), reprinted in 14 Uniform Laws Annotated 438 (1990) (as discussed above, the Uniform Trade Secrets Act has been adopted by 43 states and the District of Columbia) *id.* at 2001 Supp., 177, and many states have adopted the UTSA with modifications. For example, California does not include the “readily ascertainable” language in the definition of a trade secret. See Cal. Civ. Code § 3426.1 (1997).

In contrast, patent protection is only available if a process, machine, manufacture, or composition of matter (or any new and useful improvements thereof)<sup>176</sup> is novel, has utility, and is not obvious.<sup>177</sup> If an invention is eligible for both trade secret protection and patent protection, the inventor must make a choice because obtaining a patent will cause the public disclosure of the “secret.” In fact, as a result of the 1999 changes to the Patent Act, secrecy (and thus trade secret protection) generally will be lost no later than 18 months after the patent application is filed, even if the patent has not yet issued.<sup>178</sup>

*2. Availability of a Full Fair Market Value Deduction on the Donation of a Trade Secret.*— For the inventor wishing to make a charitable contribution of a patentable invention, the inventor will want to characterize the donation as a contribution of a patent (or the rights to a patent) so that section 1235(a) will apply and the inventor will be allowed to claim a full fair market value deduction for the value of the patent rights.<sup>179</sup> As noted above, section 1235(a) can apply even if the inventor has not obtained or applied for a patent,<sup>180</sup> as long as he or she transfers the patent rights to the charity.<sup>181</sup>

The more difficult situation involves the inventor whose work product is a trade secret, but is not patentable. As discussed above, the amount of the charitable contribution deduction will be reduced by the amount of gain that would have been taxed as ordinary income (or short-term capital gain) on a hypothetical sale of the donated property.<sup>182</sup> Thus, the key question is whether a gain from the hypothetical sale of a trade secret would be taxed as ordinary income or long-term capital gain.

Unlike the patent inventor who generally can rely on section 1235(a) for a favorable answer in most cases, the trade secret inventor must deal with

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176. 35 U.S.C. § 101.

177. 35 U.S.C. §§ 102 (novelty), 103 (non-obvious).

178. 35 U.S.C. § 122(b) (if the applicant certifies that the invention will not be the subject of a patent application in another country, the invention will not be made public by the PTO until the patent is issued).

179. If an invention qualifies for both patent and trade secret protection, favorable tax treatment should be available. The regulations and legislative history provide that section 1235 will apply as long as the invention is patentable even if no patent application has been filed. Regs. § 1.1235-2(a); S. Rep. No. 1622, 83rd Cong. 2d Sess., 439, reprinted in Falk, *supra* note 152, at B-301.

180. *Id.*

181. Presumably if the inventor wishes to assert that he or she donated patent rights, he or she will need to make the donation within one year of the first publication, public use, or offer for sale because after those dates, patent protection is no longer available. 35 U.S.C. § 102(b).

182. IRC § 170(e)(1)(A).

the general tax rules for determining when a gain will be taxed as ordinary income or long-term capital gain.

Under general tax rules, four requirements must be satisfied to generate a long-term capital gain: (i) there must be a sale or exchange; (ii) of *property*; (iii) which is a capital asset; and (iv) which has been held by the taxpayer for more than one year.

a. *Property*.—A fundamental issue is whether the trade secret will be considered “property” for tax purposes. If the trade secret is not property, presumably the inventor is merely donating his or her “services,” and as discussed above, a charitable contribution of the taxpayer’s services generates no charitable deduction.<sup>183</sup> The difficulty arises because the invention is the “fruit of the inventor’s labor,”<sup>184</sup> and the payment for the invention compensates the inventor for his or her services. The Tax Court has noted that the “difficulty increases when the inventions transferred are not patents, and thus within section 1235, . . . but rather are more amorphous assets such as trade secrets or know-how which might be characterized as capital assets under section 1221.”<sup>185</sup> The IRS and the courts generally have held that a secret process or a secret formula will be considered property (rather than services). The IRS has issued three revenue rulings<sup>186</sup> and two revenue procedures<sup>187</sup> considering this issue. In Revenue Ruling 64-56, the IRS held that the term “property” for purposes of section 351 of the Internal Revenue Code<sup>188</sup> includes anything qualifying as “secret processes and formulas . . . and any other secret information as to a device, process, etc. in the general nature of a patentable invention without regard to whether a patent has been applied for . . . , and without regard to whether it is patentable in the patent law sense . . . other information which is secret will be given consideration as ‘property’ on a case by case basis.”<sup>189</sup> The IRS specifically stated that services which are “ancillary

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183. Regs. § 1.170A-1(g). See *supra* notes 159-162 and accompanying text.

184. *Ofria v. Commissioner*, 77 T.C. 524, 535 (1981), nonacq. 1983-1 C.B. 1.

185. *Id.*

186. Rev. Rul. 55-17, 1955-1 C.B. 388, modified by Rev. Rul. 64-56, 1964-1 (Part 1) C.B. 133, amplified by Rev. Rul. 71-564, 1971-2 C.B. 179.

187. Rev. Proc. 69-19, 1969-2 C.B. 301, amplified by Rev. Proc. 74-36, 1974-2 C.B. 491.

188. IRC § 351(a) provides that “No gain or loss shall be recognized if *property* is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange, such person or persons are in control . . . of the corporation.” (emphasis added).

189. Rev. Rul. 64-56, 1964-1 (Part 1) C.B. 133 (emphasis added).

and subsidiary” to the transfer of property could qualify as “property.”<sup>190</sup> In Revenue Procedure 69-19,<sup>191</sup> the IRS set forth a list of representations which a taxpayer must make for the IRS to issue a favorable advance ruling that a transfer of information will be treated as a transfer of “property” for purposes of sections 351 and 367 of the Internal Revenue Code. The representations required include:

(i) The information being transferred “is afforded substantial legal protection against unauthorized disclosure and use under [applicable] law.”

(ii) Any services to be performed in connection with the transfer of the information will be merely ancillary and subsidiary to the property transfer (or the transferor will be separately compensated for the services).

(iii) “The ‘information’ is secret in that it is known only by the owner and those confidential employees who require the ‘information’ for use in the conduct of the activities to which it is related and adequate safeguards have been taken to guard the secret against unauthorized disclosure.”<sup>192</sup>

(iv) “The ‘information’ represents a discovery and while not necessarily patentable, the ‘information’ is *original, unique, and novel*.”<sup>193</sup>

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190. *Id.* at 134. The Revenue Ruling states that “Whether or not services are merely ancillary and subsidiary to a property transfer is a question of fact.” *Id.* Ancillary and subsidiary services may include demonstrating and explaining the use of the property, or assisting in the “start-up” of the property transferred. *Id.*

191. Rev. Proc. 69-19, 1969-2 C.B. 301, amplified by Rev. Proc. 74-36, 1974-2 C.B. 491.

192. Presumably the disclosure to the charity would not prevent the information from continuing to be considered “secret” for trade secret purposes. See *supra* notes 28-29.

193. Rev. Proc. 69-19, 1969-2 C.B. 301 (emphasis added). Generally, “original, unique, and novel” are *not* the standards for granting trade secret protection. Instead, the Uniform Trade Secrets Act merely requires that the information: (i) has independent economic value; (ii) is not generally known and is not readily ascertainable by proper means; and (iii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy. UTSA § 1(4), reprinted in 14 Uniform Laws Annotated, at 438 (1990). As discussed above, see text accompanying *supra* notes 9-12, the standards for obtaining a utility patent are that “the process, machine, manufacture, or composition of matter, or any new and useful improvement thereon” must: (i) have utility, (ii) be “novel,” and (iii) be non-obvious. 35 U.S.C. §§ 101-103.

(v) “The ‘information’ does not represent mere knowledge, or efficiency resulting from experience, or mere skill in manipulation or total accumulated experience and skill of the transferor.”

These are representations required to obtain a favorable advance letter ruling from the IRS. Courts (and presumably the IRS) would not require that all these conditions exist to conclude in an actual case that particular information is “property.”

In *DuPont v. United States*, the government conceded that a secret process was “property.”<sup>194</sup> In *Ofría v. Commissioner*,<sup>195</sup> the taxpayer developed improvements while producing a fuze bomb coupler for the Air Force under a defense procurement contract. Under the terms of the contract, the taxpayer submitted the improvements to the Air Force and was paid substantial amounts for the improvements based on the cost savings realized by the Air Force. The IRS argued that the improvements were not “property” and the money received for the transfer of those improvements was taxable as ordinary income rather than capital gain. The Tax Court held that the improvements (and all related rights therein) constituted “property,” and the transfers constituted the “sale of capital assets.” The Tax Court stated:

In general, it has been held that when an inventor is employed for the purpose of developing inventions for his employer, and the contract between the parties provides that inventions developed during the performance of the contract become the property of the employer, then the payments to the inventor are in the nature of compensation for services, taxable as ordinary income. Conversely, if the contract does not provide that the fruits of the inventor’s labor belong to the employer, and the inventor therefore has transferable property rights in his inventions, then payments in consideration of the transfer of these rights are payments in exchange for *property and may qualify as gain from the sale of capital assets*.<sup>196</sup>

The Tax Court went on to state,

These facts indicate the existence of a trade secret or other property right, and we thus find that [taxpayers] have established that each of the value engineering proposals

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194. 288 F.2d 904, 910 (Ct. Cl. 1961).

195. 77 T.C. 524 (1981).

196. *Id.* at 535-6 (emphasis added).

incorporated *trade secrets, know-how, or unpatented technology* protectable as a form of *property* . . . .

Although these inventions have not been shown to be patentable, and thus cannot qualify for capital gain treatment under section 1235, they were commercially valuable improvements over the existing art sufficiently akin to patentable inventions to qualify as capital assets under section 1221, either as *trade secrets or know-how or unpatented technology*.<sup>197</sup>

The Tax Court's language may imply that even if the invention cannot qualify as a trade secret, it might still be considered "property" under section 1221 in the form of "know-how" or "unpatented technology."

b. *Sale or Exchange*.—The second requirement for capital gain treatment is a "sale or exchange." As indicated in the following discussion by the Court of Claims in *DuPont v. United States*, it is essential that the transaction qualify as a "sale or exchange" rather than the mere provision of services.<sup>198</sup>

Were we to accept [the taxpayer's] position without qualification, it would be similar to concluding that a lawyer makes a sale of property when he discloses an estate plan to a client, and a doctor makes a sale when he discloses the diagnosis of his patient's ills [citation omitted].

In another light, however, the transfer of a trade secret may be a transaction equivalent to a sale, in the same manner that a patent assignment is considered a sale. In each case the transferee or assignee gets more than mere information. Of greater importance, he obtains what he believes to be a competitive advantage, a means for commercial exploitation and reward.

. . . .

. . . Unlike an estate plan or a diagnosis, a trade secret, as a tool for commercial competition, derives much of its value

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197. *Id.* at 540-541 (emphasis added).

198. 288 F.2d 904 (Ct. Cl. 1961). Amounts received for providing services are taxed as ordinary income. IRC § 61(a)(1).



from the fact of its secrecy. It is truly valuable only so long as it is a secret, for only so long does it provide an advantage over competitors. It follows that the essential element of a trade secret which permits of ownership and which distinguishes it from other forms of ideas is the *right in the discoverer to prevent unauthorized disclosure of the secret. No disposition of a trade secret is complete without some transfer of this right to prevent unauthorized disclosure.*<sup>199</sup>

The Court of Claims in *DuPont* concludes by stating:

When the owner of a trade secret gives the right to use the secret and in addition conveys his most important remaining right, the right to prevent unauthorized disclosure (and effectively the right to prevent further use of the trade secret by others) there is a complete disposition of the trade secret. This transaction meets the “sale” requirement of the Code and any gain would be entitled to preferential capital treatment.<sup>200</sup>

Thus, a transfer of a trade secret (along with all related rights) can qualify as a “sale or exchange.”

In contrast, the granting of a non-exclusive license to use a trade secret will not qualify as a “sale or exchange,” and any consideration received by the inventor will be treated as a royalty and taxed as ordinary income.<sup>201</sup> Furthermore, a grant of an exclusive license for a limited period of time may result in ordinary income (rather than capital gain) if “substantial rights” have been retained under the facts and circumstances.<sup>202</sup>

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199. *Id.* at 911 (emphasis added).

200. *Id.* at 912.

201. IRC § 61(a)(6) (royalty income is taxed as ordinary income). See generally Falk, *supra* note 152, at A-32.

202. Compare *Henry Vogt Machine Co. v. Commissioner*, 66 T.C. Memo (CCH) 426 (1993) (the inventor retained the right to license to others in the same geographic territory after 10 years; the court concluded that as a result, the taxpayer retained substantial rights so that the amount received would be taxed as ordinary income), with *Hooker Chemical and Plastics Corp. v. United States*, 591 F.2d 652 (Cl. Ct. 1979), *aff'g* 78-2 U.S. Tax Cas. (CCH) ¶ 9500 (Cl. Ct. 1978) (license was subject to duration limit, but court held that inventor had transferred “all substantial rights” so that gain could be taxed as long-term capital gain).

c. *Capital Asset*.—Not surprisingly, in order for the sale of an asset to generate long-term capital gain, the asset must be a “capital asset.” Under section 1221 of the Internal Revenue Code, all property held by the taxpayer which is not specifically excluded is considered a “capital asset.” The most significant exclusion for the trade secret inventor is for “stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer . . . .”<sup>203</sup> Also, the gain from the sale of property used in a trade or business which is subject to the allowance for depreciation under section 167 of the Internal Revenue Code in some situations may be taxed as ordinary income.<sup>204</sup>

As a result of the inventory exclusion of section 1221(a)(1), a professional inventor who develops and sells trade secrets on a regular basis (and therefore holds trade secrets as “inventory”) will recognize ordinary income (rather than capital gain) on the sale of the trade secrets.<sup>205</sup> On the other hand, the amateur inventor who sells a trade secret will be selling a capital asset.

d. *Held More Than One Year*.—Section 1222(3) of the Internal Revenue Code defines a “long-term capital gain” as “gain from the sale or exchange of a capital asset held more than one year . . . .” Before the enactment of section 1235, courts held that the “holding period” of a patent commences

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203. IRC § 1221(a)(1).

204. IRC § 1221(a)(2) generally excludes property used in a trade or business which is of a character subject to the allowance for depreciation under section 167 from the definition of a “capital asset.” However, under IRC § 1231, a gain from the sale or exchange of depreciable trade or business property will be taxed as a long-term capital gain if the taxpayer’s gains on the sale or exchange of section 1231 assets during the year exceed the taxpayer’s losses on the sale or exchange of section 1231 assets during the year. The Tax Court has held that a trade secret will not be depreciable under IRC § 167 unless it has a reasonably ascertainable useful life. *Yates Industries, Inc. v. Commissioner*, 58 T.C. 961 (1972). Since the “life” of a trade secret will end when it is no longer a “secret,” presumably one method for establishing the duration of the useful life would be to estimate the amount of time needed for others to discover the secret by proper means. Proper means of discovery include: (i) independent discovery, or (ii) reverse engineering. See *E. I. duPont deNemours & Co. v. Christopher*, 431 F.2d 1012 (5th Cir. 1970), cert denied 400 U.S. 1234 (1971) (discussing “proper means”).

205. Falk, *supra* note 152, at A-33. In contrast, under section 1235, upon the sale or exchange of a *patent*, there is no distinction between the professional and the amateur inventor – any gain on the sale or exchange of a patent (or a patent application, or the inchoate right to a patent) will be taxed as long-term capital gain.

when the invention is “actually reduced to practice.”<sup>206</sup> Presumably, a similar approach would apply when determining the holding period for a trade secret.<sup>207</sup>

3. *The “Related Use” Restriction Does Not Apply.*—As with a patent, since a trade secret is intangible property, the related use restriction of section 170(e)(1)(B) should not apply to a charitable gift of a trade secret.

### C. Trademarks and Charitable Giving

Like the trade secret inventor, the owner of a trademark may be able to donate his or her trademark to a charity and deduct an amount equal to the full fair market value of the trademark as a charitable contribution.

As discussed above, to obtain a full fair market value deduction on a charitable contribution of property, the gain from a hypothetical sale of the donated property would need to be taxed as a long-term capital gain (rather than ordinary income).<sup>208</sup> Traditionally the grant of a perpetual right to exploit a trademark, trade name or franchise was considered a capital transaction eligible for long-term capital gain treatment.<sup>209</sup> As discussed above in the case of a transfer of a trade secret, the general tax rules that must be met for a taxpayer to enjoy long-term capital gain treatment are: (i) there must be a sale or exchange;<sup>210</sup> (ii) of property; (iii) which is a capital asset; and (iv) which has been held by the taxpayer for more than one year.

As a result of uncertainty and conflicting court opinions, in 1969 Congress enacted section 1253 of the Code to provide that under certain situations the transfer of a trademark, trade name or franchise will *not* be

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206. The term “reduced to practice” is used in the Patent Act. 35 U.S.C. § 102(g). A district court has stated that an invention is reduced to practice by a “demonstration that the inventor’s idea works.” *Allied Chemical Corp. v. United States*, 66-1 U.S. Tax Cas. (CCH) ¶9212 (S.D.N.Y. 1966), *aff’d*, 370 F.2d 697 (2d Cir. 1967). See also Regs. § 1.1235-2(e) (“generally an invention is reduced to actual practice when it has been tested and operated successfully under operating conditions. This may occur before or after application for a patent but cannot occur later than the earliest time that commercial exploitation of the invention occurs”).

207. See Falk, *supra* note 152, at A-32. Again the donor of a patent has an advantage over the donor of a trade secret. The gain from the sale of a patent will be taxed as long-term capital gain under IRC § 1235(a) whether or not the seller has held the patent rights for more than one year.

208. IRC § 170(e)(1)(A).

209. *Seattle Brewing & Malting Co. v. Commissioner*, 6 T.C. 856, 873 (1946); See generally, Charles Falk, *Tax Planning for the Development and Licensing of Copyrights, Computer Software, Trademarks, and Franchises*, 558 Tax Mgmt. (BNA) A-44 (1997).

210. The mere granting of a limited trademark license would not be a “sale or exchange;” rather it would generate royalties taxed as ordinary income. IRC § 61(a)(6).

treated as the sale or exchange of a capital asset.<sup>211</sup> Prior to the enactment of section 1253, taxpayers, the IRS, and the courts struggled with cases in which payments for a franchise were made over a series of years and the payments were measured by a percentage of the selling price of the products sold or based on the units manufactured or sold.<sup>212</sup> Sometimes the arrangement was treated as a license,<sup>213</sup> and sometimes the arrangement was treated as the sale of a capital asset.<sup>214</sup> Section 1253(a) provides that the transfer will *not* be treated as the sale or exchange of a capital asset if “the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.” The transferor will be deemed to have retained a significant power, right, or continuing interest if he or she retains “[a] right to payments contingent on the productivity, use, or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.”<sup>215</sup>

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211. IRC § 1253(a); S. Rep. No. 552, 91st Cong., 1st Sess. (1969), reprinted at 1969-3 C.B. 554. One commentator has described section 1253 as the “evil twin” of section 1235, stating “[a]lthough both sections focus on the degree of rights retained, Code Section 1235 is designed as a safe harbor to sweep transactions into capital gain treatment, while Code Section 1253 takes the negative approach of making sure certain transactions stay out.” Advani, *supra* note 151, at 213.

212. *Id.*

213. If the transaction is treated as a license, the payer (the licensee) would be entitled to a tax deduction as long as the amount paid is an ordinary and necessary business expense, IRC § 162(a), and the amounts received by the payee (the licensor) would be taxed as ordinary income. IRC § 61(a)(6).

214. If the transaction is treated as the sale of a capital asset, the purchaser would not be entitled to a tax deduction for the full purchase price in the year of purchase (but presumably would be able to amortize the purchase price over 15 years under IRC § 197), and any gain for the seller would be taxed as long-term capital gain (assuming the trademark had been held for at least one year).

215. IRC § 1253(b)(2)(F). The other “significant power[s], right[s] or continuing interest[s]” (which will preclude treatment as a sale or exchange of a capital asset) listed in the statute are: (i) a right to disapprove any assignment of such interest, or any part thereof; (ii) a right to terminate at will; (iii) a right to prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote such products or services; (iv) a right to require that the transferee sell or advertise only products or services of the transferor; and (v) a right to require that the transferee purchase substantially all of his or her supplies and equipment from the transferor. IRC § 1253(b)(2)(A) - (E). Note that if a trademark owner does not retain the rights in clause (iii) above (the right to prescribe the standards of quality of products used or sold, etc.), the trademark owner likely will be deemed to have abandoned his or her trademark rights (because the trademark owner has granted a “naked” license). See *Dawn Donut Co., Inc. v. Hart’s Food Stores, Inc.*, 267 F.2d 358 (2d Cir. 1959); *E. I. duPont de Nemours & Co. v. Celanese Corp. of America*, 167 F.2d

Thus, like the trade secret inventor, the trademark owner can be entitled to claim a full fair market value deduction on the donation of his or her trademark, but certain requirements must be met.

As with the patent and the trade secret, the related use restriction of section 170(e)(1)(B) should not apply to a charitable gift of a trademark because a trademark is intangible property.

#### *D. Copyrights and Charitable Giving*

In sharp contrast to the tax treatment of a creative genius who donates his or her patent, trade secret, or trademark to charity, the genius who donates a copyright to charity receives almost no reward from the income tax system.<sup>216</sup> These tax rules do not encourage the flow of copyrights and related works for the benefit of charitable goals, and can result in similarly situated taxpayers being treated differently.<sup>217</sup>

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484 (C.C.P.A. 1948); J. Thomas McCarthy, *supra* note 35, at §§ 18.42 and 18.48. In effect, in order for a transfer of a trademark to qualify as a sale of a capital asset, the seller basically must transfer all of his or her rights in the trademark.

216. As a result of IRC §§ 170(e)(1)(A) and 1221(a)(3), the creator who donates a copyright will be able to deduct only his or her cost basis in the copyright (rather than the fair market value of the copyright). In addition, the “collector” who contributes tangible personal property related to intellectual property rights may find his or her income tax deduction reduced by *any* gain that would have resulted from a hypothetical sale of the donated property. IRC § 170(e)(1)(B)(i) (unless the “related use” test is satisfied). The “related use” restriction can be very important in the copyright area because works of art and manuscripts can be popular collectors’ items and can have significant value. A “collector” is distinguished from a “dealer.” A dealer is regularly engaged in the trade or business of selling the items. The dealer holds the items for sale to customers in the ordinary course of his or her trade or business. As a result, any gain on a sale by a dealer will be taxed as ordinary income, IRC § 1221(a)(1), and the amount of any charitable deduction on a contribution of the property will be limited to his or her cost basis. IRC § 170(e)(1)(A). In contrast, a “collector” holds the items for the production of income (as an investment), but does not hold the items for sale to customers. As a result, the gain on a sale by a collector can qualify as a long-term capital gain, but a full fair market value deduction will be available on a charitable gift of the item(s) only if the “related use” test will be satisfied. IRC § 170(e)(1)(B).

217. Joseph M. Dodge, *The Logic of Tax: Federal Income Tax Theory and Policy*, 88 (1989) (“horizontal equity: persons in the same position should bear the same tax burden”); Comment, *Changing I.R.C. 170(e)(1)(A): For Art’s Sake*, 37 *Case W. Res. L. Rev.* 541 (1987) (horizontal equity encompasses the principle that taxpayers [in similar situations] should pay the same tax); Joseph A. Pechman, *Federal Tax Policy*, 5 (4th ed. 1983) (horizontal equity aims to “distribute the cost of government fairly . . . among people in approximately the same economic circumstances . . .”). See also T.D. 8785, 1998-2 C.B. 494, 495 (in discussing regulations on the tax treatment of computer

1. *No Full Fair Market Value Deduction for the Creator's Donation of a Copyright.*—As discussed above, in determining the amount of the charitable income tax deduction, a preliminary question is whether the gain from a hypothetical sale of the donated property would be taxed as long-term capital gain or ordinary income.<sup>218</sup> If the gain on the sale would be taxed as ordinary income (or short-term capital gain), the charitable contribution deduction otherwise available is reduced by the amount of the gain, so that the donor can only deduct his or her cost basis in the property.

The definition of “capital asset” excludes “a *copyright*, a literary, musical, or artistic composition, a letter or memorandum, or similar property,”<sup>219</sup> held by a person who fits one of the following three descriptions: “(A) a taxpayer whose personal efforts created such property [the “creator”], (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B).”<sup>220</sup> Since the copyright or composition is not a “capital asset” in these circumstances, the gain from a hypothetical sale would not be taxed as capital gain,<sup>221</sup> and any charitable income tax deduction will be limited to the taxpayer’s basis in the donated property.<sup>222</sup>

In many cases, the taxpayer’s cost basis will be minimal – the author’s basis may be limited to the cost of his or her pencils and paper; the artist’s cost may be only the cost of the paint, brushes, canvas, and frame.<sup>223</sup> The sharp

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programs in cross-border transactions, the IRS stated this same concept in the following words: “functionally equivalent transactions should be treated similarly”).

218. IRC § 170(e)(1)(A). “Before 1950, transfers of patents and copyrights were treated substantially the same for purposes of capital gain taxation.” Note, A Comparison of the Tax Treatment of Authors and Inventors, 70 Harv. L. Rev. 1419, 1420 (1957).

219. IRC § 1221(a)(3) (emphasis added).

220. IRC § 1221(a)(3)(A)-(C).

221. Any gain on the sale would be taxed as ordinary income.

222. IRC § 1012 states that “[t]he basis of property shall be the cost of such property, except as otherwise provided . . . .”

223. See Public Hearings on General Tax Reform Before the House Committee on Ways and Means, 93d Cong., 1st Sess. 6118 (1973) (statement of Elias Newman, President, Artists Equity Association of New York, estimating the cost of producing a Rembrandt ink drawing at four cents); *id.* at 6130 (testimony of Mr. Newman stating that the manuscripts of composer Igor Stravinsky, worth \$3.5 million, would only yield a deduction equivalent to the cost of pen, paper, and ink if Mr. Stravinsky were to donate them). See Bell, *supra* note 145, at 543. Commentators have stated that, in fact, Mr. Stravinsky contemplated donating his manuscripts to the Library of Congress, but elected to sell them as a result of the restrictions on charitable contributions imposed by

contrast between the rules for the inventor of a patent or trade secret, and the copyright creator, are demonstrated by the following example:

Example #4: Texas Hank has written the definitive field guide to the wildlife on Padre Island titled “The Real Animals Hide During Spring Break.” Hank’s cost in preparing “Real Animals” was \$250 (mostly paper and pens) and Hank could sell all rights to “Real Animals” to a commercial publisher for \$100,000. In addition, Hank has patented a new invention called the “binoscope” that is as easy to carry as a pair of binoculars, but has the power of a telescope – an invaluable device for spotting distant wildlife. Hank could sell all rights in the “binoscope” to a commercial firm for \$100,000. If Hank donates all rights to “Real Animals” to a charity, he will be entitled to a charitable deduction of \$250. If Hank donates all rights to the “binoscope” to a charity, he will be entitled to a charitable deduction of \$100,000.

The harshness of this rule also is demonstrated by the fact that if the creator holds the copyright, composition, or similar property at the time of his or her death, the full fair market value will be included in his or her gross estate for federal estate tax purposes.<sup>224</sup>

Rules are in place to prevent the creator from avoiding the section 170(e)(1)(A) restriction. If the creator gives the copyright or composition to a friend or family member (or anyone else), and the donee then makes a charitable contribution of the property, the donee’s charitable income tax deduction will be restricted in the same way as if the creator had made the contribution.<sup>225</sup>

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the Tax Reform Act of 1969. Larry D. McBennett, John Paul & John Stearns, Art Update: Tax Deductions for Self-Created Works of Art, 30 Fed. B. News & J. 342, 342-43 (1983).

224. IRC § 2031(a) provides that “[t]he value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.” See Bell, *supra* note 145, at 536.

225. IRC § 1221(a)(3)(C) provides that the copyright or composition will not be a capital asset if it is held by “a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of [the creator.]” In the case of property acquired by gift, the donee’s tax basis is the same as the donor’s tax basis immediately before the gift. IRC § 1015(a) (in other words, for purposes of calculating gain on a subsequent sale by the donee, a “carryover” basis rule is used; a different rule applies for purposes of calculating a *loss* on a sale by the donee, but it is not necessary

2. *The Broad Reach of the Copyright Restriction.*—As stated above, section 1221(a)(3) applies to “a copyright, a literary, musical or artistic composition, a letter or memorandum, or *similar property* . . . .” Regulations section 1.1221-1(c)(1) states that *any* property eligible for copyright protection will be considered “similar property.” The regulation provides that “the phrase ‘similar property’ includes, for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection . . . .”<sup>226</sup>

3. *The Policies for Restricting the Amount of the Charitable Deduction for a Donation of a Copyright.*—The amount of the charitable deduction for a donation of a copyright was not limited to the donor’s cost basis until the Tax Reform Act of 1969. However, the story actually begins in 1950 when the predecessor of section 1221(a)(3) was enacted to provide that the gain from the sale of a copyright would be taxed as ordinary income rather than capital gain.

Prior to 1950, an amateur author, painter or other creative genius who held a copyright for the requisite period of time (then six months) and realized a gain on the sale of the rights would pay tax on the gain at the long-term capital gain tax rate (rather than the higher tax rate on ordinary income).

a. *The Revenue Act of 1950.*—In proposing that the gain should be taxed as ordinary income, the House Report for the Revenue Act of 1950 stated:

When a person is in the profession of inventing, or writing books, or creating other artistic works, his income from the sale of the products of his work is taxed as ordinary income. This is true whether he receives royalties from the use of his products or sells them outright, since the products of his work are held by him “primarily for sale to customers in the ordinary course of his trade or business” and are, therefore, not treated as capital assets.<sup>227</sup>

If an amateur receives royalties on his invention or book or other artistic work, they are treated as ordinary income, but if he holds his invention or book or other artistic work for 6 months and then sells it outright he can avail

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to consider those rules because IRC § 1221(a)(3)(C) refers only to the basis for calculating *gain* on a sale). Thus, although the donee is not the creator of the copyright or composition, the tax treatment for the donee will be the same as for the creator.

226. Regs. § 1.1221-1(c)(1) (emphasis added).

227. This rule is currently set forth in IRC § 1221(a)(1).



himself of a loophole which treats such a sale as the sale of a capital asset, not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. As a result, the taxpayer receives long-term capital gain treatment on the product of his personal effort.

There is no question under the income tax law but that a person may be treated as engaging in more than one trade or business at the same time, and when a person writes a book or creates some other sort of artistic work or devises an invention with the idea of realizing income on it he should be treated as being in the trade or business of writing, creating, or inventing, regardless of whether the income from his personal efforts is realized through royalties or through outright sale, and regardless of the fact that this is the first time he may have engaged in such a trade or business.

Section 290(a) of your committee's bill provides that when any person sells an invention or a book or other artistic work which is the product of his *personal effort* his income from the sale is taxed as ordinary income.<sup>228</sup>

This proposed amendment in 1950 would have treated patents in the same way as copyrights – any gain on a sale would be taxed as ordinary income.<sup>229</sup> The House Report appears to focus on the fact that a patent or copyright is created with the personal effort of the creator, rather than focusing on the fact that a “property” right is being transferred.

However, before enactment, the Senate proposed a revised bill under which the gain from a sale of a *patent* would continue to be taxed as capital gain.<sup>230</sup> In support of this change, the Senate Report stated: “your committee believes that the desirability of fostering the work of such inventors outweighs the small amount of additional revenue which might be obtained under the House bill, and therefore the words ‘invention,’ ‘patent,’ and ‘design’ have been eliminated from this section of the bill.”<sup>231</sup> The Conference Report

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228. H.R. Rep. No. 2319, 81st Cong., 2d Sess. (emphasis added), reprinted in 1950-2 C.B. 380, 420-21.

229. *Id.* at 445, 446 (as an example, the legislative history states that the gain on a sale of a formula would be taxed as ordinary income).

230. S. Rep. No. 2375, 81st Cong., 2d Sess., reprinted in 1950-2 C.B. 483.

231. *Id.* at 515. One commentator has stated, “[w]hile the justification for this encouragement has not been elaborated, it is clear that inventions, especially when patented, are considered important for our industrial progress and national defense”).

adopted the Senate version.<sup>232</sup> Thus, Congress concluded that the work of inventors should be encouraged by allowing the gain on the sale of the rights in an invention to be taxed as long-term capital gain.

Although the predecessor of section 1221(a)(3) caused any gain on a sale of a copyright to be taxed as ordinary income beginning in 1950, a creator donating a copyright to charity generally was entitled to a deduction for the full fair market value of the donated property until the Tax Reform Act of 1969 (which enacted section 170(e)(1)(A)). As discussed above, section 170(e)(1)(A) reduces the amount of the charitable deduction available by the amount of any

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Note, *supra* note 218, at 1423-1424. In the hearings prior to the adoption of the 1950 Act, a representative for the Council for Independent Businesses stated:

Our patent system is responsible, to a large degree, for the tremendous and rapid growth of the industrial phase of our economy. Although the individual inventor has never been properly rewarded for his advanced thinking, vision, and personal efforts, he deserves the major part of the credit for this great progress. His type of thinking should be encouraged rather than discouraged . . . .

If patents produce their proportionate share [of tax], it will only amount to a couple of hundred thousand dollars. For this comparatively picayune sum we would discourage our individual inventor by putting a ceiling over his opportunities, thus inhibiting his desire to create by depriving him of the major part of the reward, which is already pitifully small. So the end result will be to deny the economy of this nation many inventions potentially worth millions of dollars, to say nothing of the loss of patent stimuli to our industrial developments.

The experts who wrote this provision call it plugging up a loophole. Permitting an inventor to get some reward for his invention is not my idea of a loophole. As for "plugging up," it will certainly effectively plug up the inventor's desire to create new and better things for our people to enjoy . . . .The inventor flourishes and brings forth fruit when he feels that he is being nurtured in an atmosphere of freedom and a soil rich in opportunity.

Revenue Revisions of 1950, Hearings on H.R. 8920: An Act to Reduce Excise Taxes and for Other Purposes, Before the Committee on Finance United States Senate, 81st Cong., 2d Sess. (1950) (statements of C.E. Earle, Secretary-Treasurer of the Council for Independent Businesses and President of Breco Manufacturing Company), reprinted at Madelyn Shoheu Cantor, *Tax Policy: Copyrights and Patents*, 31 Vill. L. Rev. 931, 980-81 n.225-27 (1986).

232. H.R. Rep. No. 3124, 81st Cong., 2d Sess., reprinted in 1950-2 C.B. 580, 585 (amendments 77 and 78).

gain that would have been taxed as ordinary income (or short-term capital gain) on a hypothetical sale of the donated property.<sup>233</sup>

b. *The Tax Reform Act of 1969*.—The legislative history of the Tax Reform Act of 1969<sup>234</sup> sets forth only one reason for the “reduction” rule of section 170(e)(1)(A), and this reason has diminished. The stated reason for the rule was the ability of taxpayers at that time to derive a greater after-tax benefit from donating property to charity rather than selling it. The 1969 House and Senate Reports include the following example: “[A] taxpayer in the 70-percent tax bracket could make a gift of \$100 of inventory (\$50 cost basis) and save \$105 in taxes (70-percent of the \$50 gain if sold, or \$35, plus 70-percent of the \$100 fair market value of the inventory, or \$70).”<sup>235</sup> The key to this example is that the maximum individual income tax rate in 1969 was 70%. Thus, in 1969, it could be argued that it really was the government making the charitable donation and not the individual.<sup>236</sup> In contrast, in 2002, the maximum federal individual income tax rate is 38.6%. As a result, if this example is considered in 2002, it would provide: A taxpayer in the 38.6% tax bracket could make a gift of \$100 of inventory (\$50 cost basis) and save \$57.90 in taxes (38.6% of the \$50 gain if sold, or \$19.30, plus 38.6% of the \$100 fair market value of the inventory on a charitable donation, or \$38.60).<sup>237</sup> In other words, if the taxpayer sold the property in 2002, he would end up with \$80.70 [\$100 minus the tax of \$19.30 on the \$50 gain]. If the taxpayer donated the property to charity, he would save \$38.60 in tax – as a result, the donation would actually cost the taxpayer \$42.10 [which is \$80.70 - \$38.60]. Thus, as a result of changes in the tax rate, the rationale for enacting section 170(e)(1)(A) has faded considerably.

The legislative history of the 1969 Act also sets forth two additional reasons that may have influenced the adoption of the “reduction” rule of section

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233. See *supra* notes 141-143 and accompanying text.

234. P. L. 172, 91st Cong., 1st Sess. § 201(a)(1).

235. H. R. Rep. No. 413, 91st Cong., 1st Sess. 55, reprinted in 1969-3 C.B. 200, 234; S. Rep. No. 552, 91st Cong., 1st Sess., reprinted in 1969-3 C.B. 423, 475. The Report states, “[i]n cases where the tax saving is so large, it is not clear how much charitable motivation actually remains. It appears that the Government, in fact, is almost the sole contributor to the charity.” *Id.* at 235.

236. *Id.* In this example, if the taxpayer sold the inventory and retained the proceeds, the taxpayer would end up with \$65 [\$100 minus the tax on the gain of \$35]. If the taxpayer donated the property to charity, he would save \$70 on his taxes as a result of the charitable contribution deduction [\$100 x 70% = \$70]. Thus, the taxpayer could make a \$5 “profit” by giving the property to charity.

237. If the inventory was sold, the taxpayer would pay tax of \$19.80, and would keep the balance of \$80.70 (\$100 - \$19.30 = \$80.70).

170(e)(1)(A).<sup>238</sup> First, the legislative history states that “[t]he large amount of appreciation in many cases arises from the fact that the work of *art* is a product of the donor’s *own efforts* (as are collections of papers in many cases).”<sup>239</sup> Congress focused specifically on *art* when setting forth this rationale – thus, it appears that Congress felt that the *artist* who sells his or her work is being compensated for services.<sup>240</sup> This tax treatment is consistent with the doctor or attorney who donates his or her time for charity and is not entitled to a charitable income tax deduction.<sup>241</sup> However, this is in sharp contrast to the approach taken in the case of an inventor who sells a patent – the inventor’s efforts are deemed to have “coalesced” in the intellectual “property,” and the inventor is entitled to a full fair market value charitable contribution deduction.<sup>242</sup> If similar taxpayers are to be treated similarly, it could be argued that the creator of a copyright or composition (even an artist) should be treated in the same manner as the creative genius who wants to donate his or her patent, trade secret, or trademark to charity – in all cases, the taxpayer’s efforts should be deemed to have “coalesced” in an item of intellectual property.

Second, the legislative history states that “[w]orks of *art* are very difficult to value and it appears likely that in some cases they may have been overvalued for purposes of determining the charitable contribution deduction.”<sup>243</sup> Again, Congress was focusing on art, and not creators of copyrights in general. Since the Tax Reform Act of 1969, Congress has addressed “valuation” concerns by imposing extensive substantiation requirements on a taxpayer who seeks to claim a deduction in excess of \$5,000 for a charitable gift of property (other than cash or marketable securities).

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238. Although these two reasons are stated as support for the “related use” rule of IRC § 170(e)(1)(B) (which primarily impacts “collectors” making a donation, rather than creators), they may have been considered significant in imposing the section 170(e)(1)(A) reduction rule on creators of copyrightable works.

239. H. Rep. No. 413, 91st Cong. 1st Sess., reprinted in 1969-3 C.B. 200, 235 (emphasis added). Commentators have stated that in addition to concerns about abuses in the art world, the changes to IRC § 170(e)(1) were also in response to abuses by politicians’ contributions of their papers to libraries. See Bell, *supra* note 145, at 542. (discussing substantial deductions claimed by President Nixon for the donation of his vice presidential papers) (citing S. Rep. No. 768, 93rd Cong., 2d Sess. 10 and H.R. Rep. No. 966, 93rd Cong., 2d Sess. 10 & H.R. Rep. No. 966, 93rd Cong., 2d Sess. 10).

240. Although the legislative history discusses the *artist*, the “related use” rule would have no impact on an artist – any gain realized by an artist from the sale of the property would be taxed as ordinary income, and the charitable deduction would be reduced by that gain under the “reduction rule” of IRC § 170(e)(1)(A). The “related use” rule would impact the *collector* who would have a capital gain on the sale of the work.

241. Regs. § 1.170A-1(g).

242. See *Cupler v. Commissioner*, 64 T.C. 946, 954 (1975).

243. H. R. Rep. No. 413, 91st Cong., 1st Sess., reprinted in 1969-3 C.B. 200, 235-36 (emphasis added).

Basically, the taxpayer is required to attach IRS Form 8283 to his or her federal income tax return (Form 1040), and the Form 8283 requires extensive information regarding the donation, including a qualified appraisal.<sup>244</sup> More important, if the charity sells the property within two years of the date of the gift, the charity is required to file Form 8282 with the IRS, which will report the sale price to the IRS. Thus, the IRS will be able to match the amount of the charitable deduction claimed by the donor with the amount actually received by the charity from the subsequent sale, and if the deduction claimed is significantly higher than the amount received by the charity, the IRS will have been notified (and presumably will begin an immediate audit of the donor's tax return for the year including the donation).

#### **VI. THE CHARITABLE DEDUCTION FOR A DONATION OF COMPUTER SOFTWARE ELIGIBLE FOR OVER-LAPPING IP PROTECTION**

As discussed above, computer software may be eligible for patent, trade secret, and/or copyright protection.<sup>245</sup> In the case of a charitable donation (or

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244. Regs. § 1.170A-13(c)(3).

245. See *supra* notes 68-88 and accompanying text. Final regulations issued in 1998 characterizing computer programs for cross-border transactions appear to ignore the availability of patent protection for computer software. See Regs. § 1.861-18 (titled "Classification of transactions involving computer programs") (issued Sept. 30, 1998, T.D. 8785, 1998-2 C.B. 494). While the regulations apply "only to cross-border transactions," the preamble to the final regulations states, "Treasury and the IRS may consider whether to apply the principles of these regulations to all transactions in digitalized information as part of a separate guidance project." 1998-2 C.B. at 496. The regulations define a "computer program" as "a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result . . . a computer program includes any media, user manuals, documentation, data base or similar item if . . . [it] is incidental to the operation of the computer program." Regs. § 1.861-18(a)(3). Thus, the definition of "computer program" does not expressly address a process or method contained in computer software that may be eligible for patent protection. Although an example in the regulations refers to 'shrink-wrap licenses,' the preamble to the regulations states that "the use of the term 'shrink-wrap license' in the proposed regulations was not intended to create an inference that the regulations apply only to mass-marketed software." T.D. 8785, 1998-2 C.B. at 500.

The regulations provide that a transfer of a computer program (including the provision of services or know-how, as long as merely incidental to the transfer of the software) will be characterized in one of four ways: (i) as a transfer of a copyright right; (ii) as a transfer of a copyrighted article; (iii) as the provision of services; or (iv) as the provision of know-how. Regs. § 1.861-18(b)(1)(i)-(iv). While the regulations do not address patent protection for computer software, the regulations provide a method of analyzing a "mixed" transaction. Basically, if a part of the transaction is "de minimis," taking into account the overall transaction and the surrounding facts and circumstances,

a sale), the software inventor will prefer the tax consequences if the software is treated as a patent or a trade secret (rather than as a copyright). The “related use” restriction of section 170(e)(1)(B) should not apply since a donation of computer software (and the related patent, copyright, and/or trade secret rights) should not be considered a gift of “tangible personal property.”

A. *The Levy Case and Regulations Section 1.1221-1(c)(1)*

Only one case has considered whether an individual’s<sup>246</sup> sale of computer software will generate long-term capital gain or ordinary income under Regulations section 1.1221-1(c)(1), and the reasoning in that case is questionable.<sup>247</sup> In *Levy v. Commissioner*,<sup>248</sup> a computer programmer named David Levy developed a software program to monitor and improve the performance of certain IBM teleprocessing software. In 1984, Mr. Levy sold “all rights and interest in and to the [software], including without limitation, all source and object code and manuals and all other related documents . . .” to

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[the transaction] shall not be treated as a separate transaction, but [will be treated] as part of another transaction.” Regs. § 1.861-18(b)(2). Thus, if a taxpayer transfers patent rights in a process or method embodied in software, along with the related copyright associated with the source code and object code, and provides some confidential information regarding the operation of the computer program that is eligible for trade secret protection, and if the copyrights, the know-how, and the services are de minimis in the context of the patent rights, it may be argued that the transaction should be characterized solely as a transfer of patent rights (rather than as five separate transactions consisting of the transfer of patent rights, the transfer of copyrights, the transfer of copyrighted articles, the transfer of know-how, and the provision of services).

While the regulations refer to section 1235, the reference is merely in the context of discussing when a transfer of a copyright right is a sale or a license. A sale occurs if there is a transfer of “all substantial rights” in the copyright, and the principles of sections 1222 and 1235 may be applied in determining whether there has been a transfer of “all substantial rights.” Regs. § 1.861-18(f)(1). For a thorough discussion of the regulations, see Alan Levenson, Alan Shapiro, Robert Mattson & Ned Maguire, *Taxation of Cross-Border Payments for Computer Software*, 81 Tax Notes 1551 (1998).

246. An individual can be a “holder” under section 1235(b) (which generally provides for long-term capital gain on the sale of a patent).

247. One commentator basically dismisses the *Levy* case, stating: “[In *Levy*] the court was advised of only one type of protection, but not the other. Predictably the decision took into account only the type of protection involved in [the] case and decided the tax issues on that basis.” Marvin Petry, *Taxation of Intellectual Property: Tax Planning Guide*, § 10.05[2], pp. 10-37-10-38 (2001).

248. 64 T.C.M. (CCH) 534 (1992).

an individual for payments totaling approximately \$100,000.<sup>249</sup> The buyer then sold the software the next year to Boole & Babbage, Inc. for \$850,000.<sup>250</sup> As if that was not enough bad news for Mr. Levy, the IRS then audited his tax return and argued that the computer software was “similar property” under Regulations section 1.1221-1(c)(1),<sup>251</sup> and his gain from the sale of the software should be taxed as ordinary income rather than long-term capital gain. Mr. Levy argued that all he had transferred was the “idea” behind the software, and the “idea” was ineligible for copyright protection. The Tax Court rejected Mr. Levy’s argument stating: (i) the definition of a “capital asset” is narrowly construed,<sup>252</sup> and (ii) in fact he had transferred the source code, object code, and manuals, and these items were all eligible for copyright protection. As a result, the Tax Court concluded that Mr. Levy’s gain on the sale of the software was subject to tax at ordinary income rates. Most important, the Tax Court stated that “*the literal language of section 1.1221-1(c)(1), Income Tax Regs., provides that exception to the definition of a capital asset set forth in section 1221(a)(3) includes those assets eligible for copyright protection whether or not such protection is sought.*”<sup>253</sup> This language could be of special importance to an individual amateur software developer who desires to donate the software and all related rights to charity – it suggests that if property (such as computer software) is eligible for copyright protection, it will not be considered a “capital asset” even if the property is also eligible for patent or trade secret protection.

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249. Id. at 535. The case does not state the exact amount of payments made to Mr. Levy, but the amount of tax in dispute was approximately \$29,000. Presumably Mr. Levy had little or no tax basis in the software, and he paid a 20% long-term capital gains tax on the sale price. The tax deficiency would represent the difference between the tax if the sale price was subject to ordinary income tax (presumably taxed at a 50% rate) and the long-term capital gain tax rate (20%). Thus, the sales price likely was approximately \$100,000 [ $\$29,000 / (50\% - 20\%) = \$96,666$ ].

250. 64 T.C.M. (CCH) at 535.

251. IRC § 1221(a)(3) provides that “a copyright, literary . . . composition . . . or *similar property* . . .” will not be treated as a capital asset. (emphasis added) Regs. § 1.1221-1(c)(1) provides that “the phrase ‘similar property’ includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or *any other property* eligible for copyright protection . . .” (emphasis added).

252. Id. at 535 (quoting *United States v. Midland-Ross Corp.*, 381 U.S. 54, 56 (1965)).

253. Id. at 536 (emphasis added). It should be noted that Regs. § 1.1221-1(c)(1) was adopted in 1957. In 1957, it was still necessary for a creator seeking copyright protection to include the copyright symbol ©, year, and the name of the author when publishing the work. As a result of changes in 1976, copyright protection arises automatically when a work is fixed in a tangible medium, so that copyright protection arises without the need for the creator to affirmatively “seek” copyright protection. See 17 U.S.C. § 102(a) (“Copyright protection *subsists* . . . in original works of authorship fixed in any tangible medium of expression.”) (emphasis added).

For the reasons set forth in the next section, the author believes that such an approach is not appropriate.

### B. *Potential Challenges to Levy*

The interpretation of Regulations section 1.1221-1(c)(1) by the Tax Court in *Levy*, and its application to other situations, can be challenged on a number of grounds. Again, section 1221(a)(3) provides that “a copyright, literary . . . composition . . . or *similar property* . . .” will not be treated as a capital asset, and Regulations section 1.1221-1(c)(1) provides in relevant part: “the phrase ‘similar property’ includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or *any other property eligible for copyright protection* (whether under state or common law), but *does not include a patent or an invention* . . . .”<sup>254</sup>

1. *Construction of Regulations Section 1.1221-1(c)(1) so that the “Patent or Invention” Clause has Meaning.*—First, “it is a cardinal rule of statutory construction that significance and effect should, if possible, be accorded to every word, phrase, sentence, and part of an act.”<sup>255</sup> In order to give the phrase “but does not include a patent or an invention” meaning in Regulations section 1.1221-1(c)(1), that language should be held to exclude from the definition of “similar property” items eligible for both patent and copyright protection. The regulation should be interpreted to set forth a general rule (“‘similar property’ includes . . . any other property eligible for copyright protection”), and an exception (“does not include a patent or an invention”). Under this interpretation, the exception (“does not include a patent or an invention”) should apply to items that can be eligible for both patent and copyright protection.<sup>256</sup> This interpretation is needed because an item eligible for patent protection only would not be covered by the general rule (“‘similar property’ includes . . . any other property eligible for copyright protection”), and there would be no need to create an exception for items eligible for patent protection only.

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254. Regs. § 1.1221-1(c)(1) (emphasis added).

255. 73 Am. Jur. 2d, Statutes, § 120, p. 330. While this is a regulation rather than a statute, the same rule of construction should apply.

256. If the phrase “does not include a patent or an invention” would refer to items that are not eligible for copyright protection, those words would be meaningless in the regulation. If those items were not covered by the general rule, there would be no need to exclude them from the general rule. The phrase “does not include a patent or an invention” should also exclude items eligible for both trade secret and copyright protection.



2. *Regulation Was Not Drafted with Software in Mind.*—Second, Regulations section 1.1221-1(c)(1) was written in 1957,<sup>257</sup> when the only items eligible for both patent and copyright protection likely were designs.<sup>258</sup> Although the regulation specifically mentions designs, it fails to address designs that are eligible for both patent and copyright protection.<sup>259</sup> The writers

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257. T.D. 6243, 1957-2 C.B. 526, 536.

258. See Petry, *supra* note 247, at § 10.05[2], p. 10-37 (“This is probably because at the time these regulations were written, there were no inventions, other than designs, protectable under both laws.”).

259. As discussed above, a design may qualify for a design patent, copyright protection, and trade dress protection. See *supra* notes 89-96 and accompanying text. IRC § 1221(a)(3) precludes capital gain treatment on a sale of “a copyright, a literary, musical or artistic composition, a letter or memorandum, or *similar property . . .*” (emphasis added). In defining “similar property,” the regulations provide: “the phrase ‘similar property’ includes, for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), *but does not include* a patent or an invention, or a *design which may be protected only under the patent law and not under the copyright law.*” Regs. § 1.1221-1(c)(1) (emphasis added). The final clause of the regulation appears to add nothing. The general rule defines “similar property” as “property eligible for copyright protection.” The final clause addresses property that would not be subject to the general rule – the property in the final clause may not be protected under the copyright law. Thus, the regulation fails to deal with designs that would be eligible for both patent and copyright protection. A leading commentator has described the standards for patent protection for designs, and copyright protection for designs, and the reason why some designs will qualify only for patent protection, as follows:

Under the design patent statute, a patent may issue for an “ornamental design for an article of manufacture.” [35 U.S.C. § 171] Under the Copyright Law, as revised in 1976, a copyright may be secured for “the design of a useful [article]” (that is, “an article having an intrinsic utilitarian function that is not merely to portray the appearance of the article or to convey information”) if, and only to the extent that, such design incorporates pictorial, graphic, or sculptural features that can be identified separately from, and are capable of existing independently of, the utilitarian aspects of the article.” [citing 37 U.S.C. § 101,102(a)].

Clearly the overlap is not complete. Copyright does not extend to all ornamental designs of useful objects. [citing Esquire, Inc. v. Ringer, 591 F.2d 796 (D.C. Cir. 1978)] A patentable design must not be dictated *solely* by considerations of function, however, it need not meet the copyright standard of separate identification and independent existence.

of Regulations section 1.1221-1(c)(1) could not have anticipated computer software and the availability of patent protection for computer software (which emerged in the 1980's and become popular in the 1990's).<sup>260</sup> More important, as discussed below, the drafters of Regulations section 1.1221-1(c)(1) likely could not have anticipated that useful business items such as computer software would be eligible for copyright protection.

3. *Levy Does Not Discuss Patent Protection.*—Third, in *Levy* there was no mention that the property was eligible for patent protection, and the Tax Court did not discuss alternative forms of IP protection. Thus, it can be questioned whether the court really applied Regulations section 1.1221-1(c)(1) as a “tie-breaker.” The Tax Court appears to simply state that Mr. Levy transferred the source code, the object code, and the operating manual, and that all those items were eligible for copyright protection – there is no analysis of a patent issue in *Levy*.

4. *Conflict with the Patent Rule.*—While Regulations section 1.1221-1(c)(1) provides that “similar property” includes all property eligible for copyright protection, in the case of property also eligible for patent protection, Regulations section 1.1221-1(c)(1) would be in conflict with the legislative history and regulations of section 1235. The legislative history and regulations are clear that section 1235 (which provides that any gain on a sale of patent rights will be taxed as long-term capital gain) will apply to a sale of rights in a patentable invention even if a patent application has not been filed.<sup>261</sup>

5. *The Most Valuable Elements of Computer Software May Not be Eligible for Copyright Protection.*—As discussed above, the source code, object code, manuals, and the structure and organization of computer software can be eligible for copyright protection.<sup>262</sup> However, the actual “processes or methods embodied in the program are not within the scope of the copyright law.”<sup>263</sup> Thus, the most valuable features of computer software may not even be eligible

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260. See supra notes 84-88 and accompanying text.

261. S. Rep. No. 1622, 83rd Cong., 2d Sess., 438, 439 (1954), reprinted in Falk, supra note 152, at B-301 (“since the inventor possesses an exclusive inchoate right to obtain a patent, he may transfer his interest, whatever it may be, in any subsequently issued patent before its issuance and before as well as after he has made application for such patent.”); Regs. § 1.1235-2(a) (“It is not necessary that the patent or patent application for the invention be in existence if the requirements of section 1235 are otherwise met.”).

262. See supra notes 72-79 and accompanying text.

263. H. R. Rep. No. 1476, 94th Cong., 2d Sess. 57 (1976), reprinted in 1976 U.S.C.C.A.N. 5659, 5670 (referring to Pub. L. No. 94-553, 90 Stat. 2541 (1976) (codified at 17 U.S.C. § 101 et seq.)).

for copyright protection. Those valuable features may instead be protected by patent law (or trade secret law). In those cases, the tax consequences should be based on the treatment of the software as property eligible for patent protection (or trade secret protection), rather than as property eligible for copyright protection. It should be noted that many patents (or trade secrets) may be transferred with written instructions or descriptions. While the written instructions or descriptions may be eligible for copyright protection, the availability of this limited copyright protection should not prevent the gain on the sale of the patent (or trade secret) from being taxed at the long-term capital gain rate. One commentator has argued that the copyright rule of Regulations section 1.1221-1(c)(1) should not apply if the taxpayer is not relying on copyright protection.<sup>264</sup>

6. *The Policy for Reducing the Charitable Deduction Does Not Apply to Useful Business Creations Such as Computer Software.*—Most important, under the language of the statute, and based on the policy behind the statutes involved, “computer software” should not be treated as “similar property” under section 1221(a)(3). Section 1221(a)(3) excludes from the definition of “capital asset” the following: “a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property . . .” This subsection was last amended in 1969,<sup>265</sup> several years before the Copyright Act was amended (in 1980) to include computer software among the items eligible for copyright protection. The items specifically listed in section 1221(a)(3) – “a literary, musical, or artistic composition, a letter or memorandum” are very different from computer software – computer software often has a specific business application and provides instructions to a machine (and can be said to actually become a part of the machine when used).<sup>266</sup> Computer software typically derives most of its value from its business use by others, much like a utility patent. In contrast, “literary, musical or artistic compositions or letters or memoranda”<sup>267</sup> are in the nature of *artistic* activities (rather than business activities involving machines). “Part of Congress’ broad remedial purpose in enacting section 1235 was to ‘provide an incentive to inventors to contribute to the welfare of the Nation.’”<sup>268</sup> Computer software eligible for patent (and/or trade secret) protection can contribute to the productivity and welfare of the

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264. See Falk, *supra* note 209, at A-22.

265. P. L. No. 172, 91st Cong., 1st Sess. § 514(a) (the Tax Reform Act of 1969).

266. See *supra* note 68.

267. IRC § 1221(a)(3).

268. *Gilson v. Commissioner*, 48 T.C.M. at 930 (quoting S. Rep. No. 1622, 83rd Cong., 2d Sess. 439 (1954); H. R. Rep. No. 1337, 83rd Cong., 2d Sess. A280 (1954)).

“Nation” in the same manner as other inventions. Accordingly, the same incentives provided to other inventors should be available to the software developer. The mere fact that the source code, object code, and manuals may be protected by copyright should not change the tax consequences. In many ways computer software with useful business applications will not be “similar” to “literary, musical or artistic compositions or letters or memoranda.”<sup>269</sup>

*C. Considerations for the Developer Planning a Donation of Computer Software Under Current Law*

The difficulties facing the individual developer who wishes to donate all of his or her rights to computer software under current law can be illustrated by the following example.

Example #5: World famous marine biologist Texas Hank has done it again! This time Hank has developed new software called “Fish Forever,” and environmental protection groups, commercial fishing enterprises and several nations cannot wait to start using the software. Hank’s cost in developing the software was minimal, but now the software is worth millions. The software can be described as an inventory control and production restraint system. In order to protect and maintain fish populations, nations, environmental groups and commercial fishing enterprises may desire to enter into agreements to measure (and restrict) fishing in certain areas at certain times. A popular slogan for the software is “if you catch too many salmon downstream, too few will make it upstream.” Fish Forever allows participating fishing enterprises to report their “catch” in an area, and the software will compile the data and compare the “catch” to historical patterns, projected supply, anticipated needs, etc., and issue warnings and/or directives for the next day, week, month or year. While the guidelines and thresholds need to be established by the parties involved, Fish Forever can allow the system to work smoothly and efficiently. Texas Hank could assign all of his rights (or assign or license key rights) to a software development company that could exploit the software, and Texas Hank would receive substantial amounts of money. However, Texas Hank would prefer that his favorite charity receive all money from the exploitation of Fish Forever, so that they can use the money to build homeless

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269. Petry, *supra* note 247, at 10-37.

shelters. Hank would like to claim a full fair market value income tax deduction on the charitable contribution.

Texas Hank will want to consider the best way(s) to protect the software so that his favorite charity will be able to successfully exploit the computer software, but Hank also needs to consider how his actions may impact the size of his charitable deduction for income tax purposes. If Texas Hank files the software for copyright protection<sup>270</sup> and then expressly donates the “copyright” to his favorite charity, it may be difficult for Hank to avoid section 170(e)(1)(A) (and as a result, his charitable tax deduction may be limited to his out-of-pocket expenses in developing the software). In contrast, if Texas Hank donates his rights in the software and never asserts copyright protection (and never refers to a copyright interest when transferring the software to the charity), Texas Hank could argue that the software is a trade secret (or is patentable), and that his contribution of the trade secret (or patent) will be eligible for a full fair market value deduction because section 170(e)(1)(A) should not apply. Nevertheless, a court might follow the approach taken in *Levy* and conclude that since the software was “eligible” for copyright protection, Regulations section 1.1221-1(c)(1) would cause any gain on a hypothetical sale to be taxed as ordinary income (and will prevent Texas Hank from obtaining a charitable deduction for any value of the software in excess of his cost basis in the software).

In documenting the transfer of the software to charity, Texas Hank is in a particularly difficult planning situation. If the transfer document recites that Texas Hank is transferring a copyright interest in the software to charity, the IRS may assert that section 170(e)(1)(A) applies and that Texas Hank’s tax deduction is limited to his cost basis in the computer software. On the other hand, if the transfer document makes no mention of the transfer of a copyright interest in the software, the IRS may assert that Hank has retained a copyright interest, and thus made a gift of only a “partial interest” in the property (because he retained the copyright).<sup>271</sup> Under the partial interest rule of section 170(f)(3), Texas Hank would not be entitled to any charitable contribution deduction.

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270. Filing with the U.S. Copyright Office would be a clear indication of claiming copyright protection. However, filing is not necessary to obtain copyright protection. Neil Boorstyn, *Boorstyn on Copyright*, § 9.05[1], pp. 9-31 (“Under the 1976 Act, a work created after January 1, 1978 is protected upon creation [citing 17 U.S.C. § 302(a)], that is, when it is fixed for the first time in a copy or phonorecord”). As a result, the IRS might assert that the software is a literary work entitled to copyright protection even if Texas Hank makes no affirmative attempt to claim copyright protection. See also *supra* note 56.

271. See *supra* notes 147-149 and accompanying text.

Note that since Texas Hank's cost basis in the software is minimal, his risk from the potential application of the "partial interest" rule is minimal. In effect, there would not be much difference between deducting nothing (because of the partial interest rule of section 170(f)(3)) and deducting a small amount under the "copyright" rule of section 170(e)(1)(A). As a result, Texas Hank might be well-advised to refer to the patent rights (and all other rights) in the transfer document but avoid any reference to copyright protection.

## VII. PROPOSALS FOR EXCLUDING COMPUTER SOFTWARE ELIGIBLE FOR PATENT PROTECTION FROM THE OLD COPYRIGHT RESTRICTION

### A. *Proposal for an IRS Administrative Announcement*

For the reasons stated above, under current law, neither section 1221(a)(3) (requiring that gain on a sale be taxed as ordinary income) nor the reduction rule of section 170(e)(1)(A) should apply to a charitable contribution of computer software that is eligible for trade secret or patent protection.<sup>272</sup> Unfortunately, the Tax Court in *Levy*,<sup>273</sup> in applying Regulations section 1.1221-1(c)(1), indicates that section 1221(a)(3) (and indirectly, the reduction rule of section 170(e)(1)(A)), will apply whenever property eligible for copyright protection is contributed to charity.<sup>274</sup> No amendment of the statute should be necessary because the result suggested by *Levy* is not mandated by the statute. Nevertheless, the uncertainty caused by the interpretation of Regulations section 1.1221-1(c)(1) in *Levy* may have a chilling effect on software developers considering a charitable gift. Accordingly, a pronouncement by the IRS (in the form of an Announcement or Revenue Ruling) would be appropriate to encourage charitable gifts of computer software eligible for patent protection. A sample Revenue Ruling is attached as Appendix A.

### B. *The Artist-Museum Partnership Bill*

A bill has been introduced in Congress that would address certain concerns about donating copyrights (and related rights) to charity, but as currently drafted the bill would help software developers only in limited

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272. See *supra* notes 248-269 and accompanying text.

273. 64 T.C.M. (CCH) 534, 536 (1992).

274. The *Levy* case actually holds that the gain from a sale of property eligible for copyright protection will be taxed as ordinary income (rather than being taxed as capital gain). *Id.* at 536. Since the gain on the sale would be taxed as ordinary income, the reduction rule of IRC § 170(e)(1)(A) would apply to a charitable contribution of the property.

situations. As its name suggests, the Artist-Museum Partnership Act is designed to encourage artists to donate their paintings, sculptures, and other works of art to museums, but the bill's language could apply even if the donated property is not "art" and even if the receiving charity is not a museum.<sup>275</sup>

1. *The Current Bill.*—The bill would allow a full fair market value deduction for a charitable contribution of "any *literary*, musical, artistic or scholarly composition, or similar property, or the copyright thereon (or both)."<sup>276</sup> However, the bill would not reach all copyrights (and compositions and similar property),<sup>277</sup> and would impose the "related use" restriction, which certain gifts would not satisfy. In order for the donor to obtain a fair market value deduction, the bill requires that the following conditions be satisfied:

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275. Since the charitable giving rules for works of art have been considered extensively elsewhere, see articles listed at *supra* note 145, this Article will not consider whether the special rules that direct gifts of art work to museums are appropriate.

276. S. Bill 694 (emphasis added), the Artist-Museum Partnership Act, 107th Cong., 1st Sess. (April 4, 2001) (sponsored by Senator Leahy). A similar bill was proposed several years ago. H.R. 1285, The National Heritage Resource Act (Feb. 7, 1983); See McBennett, Paul & Stearns, *Art Update: Tax Deductions for Self-Created Works of Art*, 30 Fed. B. News & J. 342 (June, 1983) ("In 1981, The Presidential Task Force on the Arts and Humanities recommended that the artist receive the same tax treatment as the private collector or other donor for the charitable contribution of a work of art or manuscript.").

277. The bill provides that the full fair market value deduction will not be available for a donation of letters, memos or similar property which are produced by or for an individual while the individual is an employee of any person (including any government agency or instrumentality), "unless such letter, memorandum, or similar property is entirely personal." Presumably, this provision is a reaction to charitable contribution deductions claimed when various papers relating to Presidents Eisenhower, Johnson and Nixon were donated. McBennett, Paul & Stearns, *supra* note 271, at 342; see also *supra* note 218, at 1423 ("Perhaps the best-known transaction was General Eisenhower's sale of *Crusade in Europe* for a reported \$1,000,000, all of which was taxed as capital gain."); Cantor, *supra* note 231, at 973 n.190 ("President Nixon . . . donated his vice presidential papers and got the full fair market value as a deduction before the passage of the Tax Reform Act of 1969"). Also, in a radical departure from current law, see *supra* note 147-149, the Artist-Museum Partnership Bill provides that in these situations the tangible literary, musical, artistic or scholarly composition or similar property will be treated as an item of separate property from the underlying copyright. Currently the "partial interest" rule has been interpreted to require that to obtain any charitable deduction whatsoever, it is necessary to always contribute the underlying copyright when an item subject to copyright protection is donated (assuming that the donor owns the copyright). IRC § 170(f)(3). See *supra* note 148.

- (i) the charity's use of the property must be "related to the purpose or function constituting the basis for the donee's exemption" (commonly referred to as the "related use" requirement);
- (ii) the property must have been created by the personal efforts of the taxpayer no less than 18 months before the contribution;<sup>278</sup>
- (iii) "the taxpayer receives from the donee a written statement" that the related use requirement will be satisfied;
- (iv) the written appraisal attached to the donor's tax return includes evidence of previous sales or displays of the donor's similar property; and
- (v) the maximum deduction cannot exceed the donor's adjusted gross income from the sale or use of property created by the personal efforts of the donor, and "income from teaching, lecturing, performing or similar activity with respect to the property described."<sup>279</sup>

Many of these restrictions seem reasonable if an artist is donating a work to a museum.

Example #6: Leonardo da Vino has created a masterpiece titled "Man Stretching Surrounded by Circle." Leo desires to donate this painting to his favorite museum. If the Artist-Museum Partnership Act has been enacted as proposed, Leo must wait 18 months, but otherwise he likely will have no significant problem satisfying the requirements for a full fair market value deduction. The appraiser will be able to attach evidence of previous sales,<sup>280</sup> and the amount of the deduction

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278. The 18 month requirement likely is a reaction to the concern that an artist might create a work with the intention of merely claiming a charitable deduction for the work. The concern is that an artist facing a significant tax bill might attempt to create a work near the end of the year for the sole purpose of creating the work, donating it to charity, and obtaining a tax deduction. The taxpayer who would attempt such a strategy could encounter a number of difficulties, and it is questionable whether a separate statutory provision is needed to deal with this possibility.

279. Artist-Museum Partnership Act, 107th Cong., 1st Sess. (April 4, 2001).

280. Presumably, this requirement was included to help identify valuation abuses – prior sales by an artist may be an indication of value for current works; in the case of a completely new artist, it can be more difficult to determine the fair market value of the artwork.



likely will not exceed Leo's adjusted gross income for the year from the sale of paintings (because Leo is very productive, and his work is selling well).<sup>281</sup>

Three examples of donations meeting the "related use" test are: (i) a gift of artwork to a museum that intends to display the artwork in its galleries; (ii) a gift of artwork to a university that will place the artwork "in its library for display and study by art students;" and (iii) a gift of furnishings used by the charity "in its offices and buildings in the course of carrying out its functions."<sup>282</sup> However, if the charity plans to sell the property after it is received and use the proceeds for its charitable purpose, this will *not* be treated as a related use.<sup>283</sup>

The "related use" rule is especially important in the art world, in which substantial value may be tied up in the tangible work of art. This rule will prevent an art *collector*<sup>284</sup> from claiming a full fair market value charitable income tax deduction unless he or she gives the art to a museum or other institution that will use the art in a manner related to the organization's charitable purpose.<sup>285</sup> The importance of this rule can be illustrated by the following example:

Example #7: Leonardo da Vino had another masterpiece known as "The Lady with the Mystic Smile" which he painted several years ago. Leo sold the painting to his good friend Mona Lisa when Leo was still a starving amateur painter/sculptor/architect/engineer/scientist/writer for \$10,000. Leo's career took off shortly thereafter and today "The Lady" would sell for \$10 million. If Mona contributes "The Lady" to a museum that will display the painting as one of its works of art, Mona will be entitled to a charitable income tax deduction

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281. The "adjusted gross income" test likely is another attempt to reduce valuation abuses – the amount of the deduction cannot exceed the amount Leo earns during the year from selling other works.

282. Regs. § 1.170A-4(b)(3)(i).

283. *Id.* ("if the painting is sold and the proceeds used by the organization for educational purposes, the use of the property is an unrelated use").

284. This rule would not impact someone who is regularly engaged in the trade or business of selling art (such as an art dealer) and holds the artwork as inventory, because inventory is not considered a "capital asset." IRC § 1221(a)(1). As a result, if the property were held as inventory, the sale of the property would not be eligible for capital gain treatment (because the gain from any sale of inventory will be taxed as ordinary income).

285. A university could also use the art for a "related use" if it used the art in teaching art appreciation classes. Regs. § 1.170A-4(b)(3)(i).

of \$10 million. However, if Mona gives the painting to her favorite Church which will sell the painting for \$10 million and use the proceeds to build homeless shelters, Mona will only be entitled to a charitable income tax deduction of \$10,000.

The impact of the “related use” rule directs art collectors (who are charitably inclined) to donate their pieces (or in some cases their collections) to museums and other institutions which will display the works, rather than donating those works to public charities that would sell the works and use the proceeds for other charitable purposes.<sup>286</sup>

While these rules may be appropriate in the context of gifts of art to museums, these restrictions will be arbitrary and exclusionary in other situations. The “related use” restriction will be a major problem for gifts of certain copyrights because it may be unlikely that the donor’s favorite charity (much less any charity) would be able to retain the copyright and fully exploit the copyright in a “related use.”

Example #8: Inspired by a recent trip to Brazil, Charles has just finished writing a steamy novel titled “Rain Forest Rendezvous.” Charles has never written a novel before (and in fact has never written any fiction before) and the subject of the novel has absolutely nothing to do with Charles’ occupation. Being of a generous nature, Charles desires to donate all his rights in “Rain Forest” to his Church which will sell all the rights to a publishing company, and then the Church will use the money to support its food pantry service for the poor. Under the Artist-Museum Partnership Bill, even if Charles waits 18 months before making the donation, Charles will be prevented from claiming a full fair market value deduction for the gift of “Rain Forest” for a number of reasons. First, as a new novelist, the appraiser will not be able “include evidence of previous sales or displays of the donor’s similar

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286. In a colloquy between Congressman Frelinghuysen of New Jersey and Chairman Wilbur Mills (of the House Ways and Means Committee) before the provision benefitting museums was added to the Tax Reform Act of 1969, Congressman Frelinghuysen stated, “As a trustee of a metropolitan museum in New York, it does strike me as a harsh provision, because it almost surely will prevent the transfer to a museum of certain gifts of that character . . . . It would seem to me there might have been a proviso saying that if the gift were to a museum, which would keep such tangible personal property, there would not be any tax.” 115 Cong. Rec. 22571 (1969), quoted in Robert Anthoine, *Deductions for Charitable Contributions of Appreciated Property* – The Art World, 35 Tax L. Rev. 239, 244 (1980).

property.”<sup>287</sup> Second, since Charles will have no income from the sale or use of novels created by his personal efforts, he will not be entitled to any deduction anyway. Third, since the Church plans to immediately dispose of its rights in the book, it will not be using the property in a “related use.”

Example #9: Texas Hank, the world-renowned marine biologist conducting research on Padre Island, has triumphed again! This time he has developed “Survivor Strategy” a new computer software program that will manipulate data regarding an animal, plant or other life form, with data regarding the environmental conditions of multiple locations, to predict the chances of survival for a life form in the specified areas. The science world, including countless charitable organizations, cannot wait to obtain the new software because it will be invaluable in deciding how and where to relocate life forms to avoid extinction. Software development companies are ready, willing and able to develop and distribute the software and pay Hank big dollars, if he will release all his rights in the software. Hank desires to donate all his rights to charity, but no single charity has the capacity to produce and distribute the software. Hank would prefer to contribute Survivor Strategy to his favorite charity which could sell all rights in the software to a software development company.

If the reduction rule of section 170(e)(1) currently would prevent Hank from obtaining a full fair market value deduction, the Artist-Museum Partnership Bill likely would not be of any assistance to Hank. Even assuming that Hank waits 18 months to make the contribution, there is no single charity capable of retaining the software and fully exploiting the software (thus, the “related use” test will not be satisfied). Furthermore, Hank would need to have records of previous sales or displays that could be attached to the written appraisal, and his adjusted gross income for the year from similar activities would need to exceed the value of Survivor Strategy.

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287. Artist-Museum Partnership Act, 107th Cong., 1st Sess. (April 4, 2001).

Under the Artist-Museum Partnership Bill as currently drafted, the “related use” problem would arise any time the donor desires to contribute computer software that will be of significant benefit to businesses in a particular industry – there will be no charity which can fully utilize the software in a manner related to its charitable function (because the software performs a business function).

*2. Proposed Revision to the Bill to Address Computer Software.*—The Tax Reform Act of 1969 and the Artist-Museum Partnership Bill are concerned primarily with gifts of artwork. Apparently, a major aim is to direct charitable gifts of artwork to museums. This is evident from the imposition of the “related use” rule of section 170(e)(1)(B). Since it appears that great effort and analysis have been conducted to try to establish rules for gifts of artwork, this Article proposes no changes to the Artist-Museum Partnership Bill in regards to gifts of artwork (as a result, gifts of artwork would be subject to the “related use” rule). However, in the interest of treating computer software that is eligible for both patent and copyright protection in a manner similar to charitable gifts of patents, a revised version of the Artist-Museum Partnership Bill is attached as Appendix B, which would exclude charitable gifts of such software from the reduction rule of section 170(e)(1)(A) (and would not impose a “related use” requirement on such gifts).

**Appendix A****[Sample Revenue Ruling Permitting a Full Fair Market Value  
Deduction on a Charitable Contribution of Computer Software  
Eligible for Copyright Protection and Patent Protection]****[Summary]**

The fair market value of an undivided present interest in computer software that is eligible for both copyright and patent protection, which is contributed by the developer of the software to an organization described in section 170(c) of the Internal Revenue Code of 1986, constitutes an allowable deduction as a charitable contribution, to the extent provided in section 170, in the taxable year in which such property is contributed.

**[Text of Ruling]**

Advice has been requested with respect to the treatment for Federal income tax purposes of the transfer, under the circumstances described below, of an undivided present interest in computer software by the developer of the software to an organization described in section 170(c) of the Internal Revenue Code of 1986. Certain processes and methods of the software are eligible for patent protection, and the literary features of the software (such as the source code, the object code and the manuals, as well as the structure, sequence or organization) are eligible for copyright protection.

*A*, an individual, the developer and owner of the software, contributed the software to *C*, an organization described in section 170(c) of the Code.

Since the transfer of the undivided present interest in the software is a transfer of a substantial interest in property, any royalties attributable to the software, which are earned subsequent to the transfer and paid to *C* as a result of such transfer, constitute income to the organization and not to *A*.

Section 170 of the Internal Revenue Code of 1986 as amended (the “Code”) provides in part as follows:

- (a) ALLOWANCE OF DEDUCTION. –
  - (1) GENERAL RULE. – There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.

....

(e) Certain contributions of ordinary income and capital gain property.

- (1) GENERAL RULE. The amount of any charitable contribution of property otherwise taken into account shall be reduced by the sum of:
  - (A) the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution . . . .)

Section 1235(a) of the Internal Revenue Code provides in part that “A transfer . . . of property consisting of all substantial rights to a patent . . . by any holder shall be considered the sale or exchange of a capital asset held more than 1 year . . . .”

Section 1221(a)(3) excludes from the definition of a capital asset, “a copyright, a literary, musical or artistic composition, a letter or memorandum, or similar property held by – (A) a taxpayer whose personal efforts created such property . . . .”

Section 1.170-1(c) of the Income Tax Regulations provides that if a contribution is made in property other than money, the amount of the deduction is determined by the fair market value of the property at the time of the contribution.

Section 1.1221-1(c)(1) of the Income Tax Regulations provides in part that “the phrase ‘similar property’ [for purposes of Section 1221(a)(3)] includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.”

It is held that a deduction will be allowable to *A* for his contribution of computer software, and such deduction will be allowable for the taxable year in which the property is contributed. The amount of the allowable deduction will be the fair market value of the software, such fair market value being a question of fact to be determined upon the examination of *A*'s income tax return for the year in which the contribution is claimed as a deduction.

## Appendix B

### [REVISED VERSION OF THE ARTIST-MUSEUM PARTNERSHIP ACT] A BILL

To amend the Internal Revenue Code of 1986 to provide that a deduction equal to fair market value shall be allowed for charitable contributions of literary, musical, artistic, or scholarly compositions created by the donor, **and for charitable contributions of computer software eligible for patent protection donated by an individual developer.**

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

#### SECTION 1. SHORT TITLE.

This Act may be cited as the 'Artist -Museum Partnership Act' .

#### SEC. 2. CHARITABLE CONTRIBUTIONS OF CERTAIN ITEMS CREATED BY THE TAXPAYER.

(a) IN GENERAL- Subsection (e) of section 170 of the Internal Revenue Code of 1986 (relating to certain contributions of ordinary income and capital gain property) is amended by adding at the end the following new paragraph:

~~'(7) SPECIAL RULE~~ **RULES FOR CERTAIN CONTRIBUTIONS OF COMPUTER SOFTWARE OR COPYRIGHTS AND** LITERARY, MUSICAL, OR ARTISTIC COMPOSITIONS-

'(A) IN GENERAL- In the case of a qualified artistic charitable contribution **-or a qualified software charitable contribution --**

'(i) the amount of such contribution shall be the fair market value of the property contributed (determined at the time of such contribution), and

'(ii) no reduction in the amount of such contribution shall be made under paragraph (1).

`(B) QUALIFIED ARTISTIC CHARITABLE CONTRIBUTION- For purposes of this paragraph, the term `qualified artistic charitable contribution' means a charitable contribution of any literary, musical, artistic, or scholarly composition, or similar property, or the copyright thereon (or both), but only if--

`(i) such property was created by the personal efforts of the taxpayer making such contribution no less than 18 months prior to such contribution,

`(ii) the taxpayer--

`(I) has received a qualified appraisal of the fair market value of such property in accordance with the regulations under this section, and

`(II) attaches to the taxpayer's income tax return for the taxable year in which such contribution was made a copy of such appraisal,

`(iii) the donee is an organization described in subsection (b)(1)(A),

`(iv) the use of such property by the donee is related to the purpose or function constituting the basis for the donee's exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described under subsection (c)),

`(v) the taxpayer receives from the donee a written statement representing that the donee's use of the property will be in accordance with the provisions of clause (iv), and

`(vi) the written appraisal referred to in clause (ii) includes evidence of the extent (if any) to which property created by the personal efforts of the taxpayer and of the same type as the donated property is or has been--



`(I) owned, maintained, and displayed by organizations described in subsection (b)(1)(A), and

`(II) sold to or exchanged by persons other than the taxpayer, donee, or any related person (as defined in section 465(b)(3)(C)).

**`(C) MAXIMUM DOLLAR LIMITATION FOR QUALIFIED ARTISTIC CHARITABLE CONTRIBUTION; NO CARRYOVER OF INCREASED DEDUCTION-** The increase in the deduction under this section by reason of ~~this paragraph~~ **subparagraph (B)** for any taxable year--

`(i) shall not exceed the artistic adjusted gross income of the taxpayer for such taxable year, and

`(ii) shall not be taken into account in determining the amount which may be carried from such taxable year under subsection (d).

**`(D) ARTISTIC ADJUSTED GROSS INCOME-** For purposes of ~~this paragraph~~ **subparagraphs (B) and (C)**, the term 'artistic adjusted gross income' means that portion of the adjusted gross income of the taxpayer for the taxable year attributable to--

`(i) income from the sale or use of property created by the personal efforts of the taxpayer which is of the same type as the donated property, and

`(ii) income from teaching, lecturing, performing, or similar activity with respect to property described in clause (i).

**`(E) PARAGRAPH NOT TO APPLY TO CERTAIN CONTRIBUTIONS-** Subparagraph (A) shall not apply to any charitable contribution of any letter, memorandum, or similar property which was written, prepared, or produced by or for an individual while the individual is an officer or

employee of any person (including any government agency or instrumentality) unless such letter, memorandum, or similar property is entirely personal.

“(F) COPYRIGHT TREATED AS SEPARATE PROPERTY FOR PARTIAL INTEREST RULE- In the case of a qualified artistic charitable contribution, the tangible literary, musical, artistic, or scholarly composition, or similar property and the copyright on such work shall be treated as separate properties for purposes of this paragraph and subsection (f)(3).”.

**“(G) QUALIFIED SOFTWARE CHARITABLE CONTRIBUTION. For purposes of this paragraph, the term “qualified software charitable contribution” means a charitable contribution of all patent and other rights relating to computer software, but only if—**

**(i) such contribution is made by an individual who is not regularly engaged in the trade or business of developing and selling computer software, and the software was created by the personal efforts of the taxpayer making the contribution;**

**(ii) one or more features of the computer software contributed is eligible for U.S. patent protection;**

**(iii) the taxpayer--**

**“(I) has received a qualified appraisal of the fair market value of such property in accordance with the regulations under this section, and**

**“(II) attaches to the taxpayer's income tax return for the taxable year in which such contribution was made a copy of such appraisal; and**

**(iv) the donee is an organization described in subsection (b)(1)(A),**

(b) EFFECTIVE DATE- The amendment made by this section shall apply to contributions made after the date of the enactment of this Act in taxable years ending after such date.