Current Tax Issues
in
IP Development & Technology Transfers

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Hypothetical 1
Patent Development

Peeyew, Inc., a perfume manufacturing company, decides to create a new perfume to sell to teenage girls. Discuss the deductibility of the following expenses incurred by Peeyew during the current year:

a. $100,000 to actually develop the basic scent.
b. $25,000 to determine whether the perfume causes an allergic reaction.
c. $35,000 to develop alternative perfumes with different scents and colors.
d. $50,000 to initially market the perfume.
e. $35,000 in attorney's fees in the prosecution of a patent application.

Notes:

Hypothetical 2
Patent Development

In Year 1, calendar-year Taxpayer spends $60,000 to develop a process for which he seeks patent protection. On July 1, Year 3, Taxpayer first realizes benefits from the marketing of products resulting from this process and submits a patent application. On July 1, Year 5, the Patent Office issues a patent protecting his process.

a. If Taxpayer wishes to deduct in full the $60,000 research or experimental expenditures under section 174(a), what is the proper taxable year of deduction? How is an election to use the "current expense method" made? What if Taxpayer fails to currently deduct the expenditures in the proper year?

b. If Taxpayer wishes to treat the $60,000 as deferred expenses amortized ratably over 60 months under section 174(b), what is the proper amount of deduction, if any, in Years 1-5? How is an election to use the "deferred expense method" made?

c. After the initial election is made, can Taxpayer later change methods? How?

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Hypothetical 3
Patent Acquisition

Best Cleaners, Inc. will purchase all the assets of an existing dry cleaning business from Comet Cleaners, Inc., including: (1) a patent obtained by Comet on a dry cleaning chemical that does not dissolve buttons; and (2) the domain name "drycleaning.com" that is registered by Comet. What are the tax consequences to Best Cleaners of the purchase of the patent and domain name?

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Hypothetical 4
Trade Secret Acquisition

Hessaco, Inc., a calendar-year taxpayer, purchases from its competition a secret technique on how to refine crude oil on March 10, Year 1, and immediately begins applying the technique in its refinery business. Hessaco agrees to pay its competition an initial payment of $1.8 million on March 10, Year 1 and contingent payments in later years pursuant to an agreed-upon formula. What is the proper tax treatment of the initial $1.8 million payment? What is the proper tax treatment of a $850,000 contingent payment made on January 1, Year 2? What is the proper tax treatment of a $150,000 contingent payment made on January 1, Year 17?

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Hypothetical 5
Patent Acquisition

On January 1, Year 1, PappaJoes, Inc., a local pizzeria, purchased from a young inventor a patent for tofu-filled pizza crust for $80,000, and immediately began using the patented technique. PappaJoes estimated that the patented pizza would produce $120,000 of income during its 8-year useful life, after which it would have no salvage value. The patent, which was not acquired as part of the acquisition of a trade or business and which had a remaining legal life of 18 years, actually produced $60,000 of income within the first taxable year, $30,000 of income in the second year, and only $1,200 of income in the third year. Is the patent amortizable under section 197? If not, is the patent depreciable under section 167? Assuming section 167 applies, what are the proper deductions for Years 1-3 under the straight-line method and income forecast method?

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Hypothetical 6
Patent Acquisition

Genius, a professional inventor, granted to Larry the exclusive right to make, use, and sell certain products that utilize the processes claimed in one of Genius' patents. As consideration for the transfer, Larry agreed to pay Genius royalty fees equal to 7% of net sales.

a. Is Larry entitled to deduct each year's payment to Genius?

b. What if Genius, instead of transferring the "exclusive right to make, use, and sell," decided to license the patented technology and accompanying know-how, subject to a field of use restriction, for a term of 18 years (two years less than the remaining life of the patent), and Larry agreed to pay Genius 3% of net sales. Would Larry be entitled to deduct each year's payment to Genius?

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Hypothetical 7

Software Transfer

Your client, State Street Company, is the developer and owner of a well-known patented software relating to financial investments. Recently, a major competitor of State Street offered a very attractive price for the patented software. Your client is considering selling it, but would like to know the tax consequences of a sale. What is your advice? Would your advice be different if the self-developed software was copyrighted rather than patented? Would your advice be different if your client was an individual rather than a company?

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Hypothetical 8
Patent Transfer

Tom was hired by Lockheed Aircraft Corp. as a layout draftsman to design window installations for aircraft being developed. His application for employment contained the following agreement: "In consideration for the wages to be paid to me in the event of my employment, I hereby agree to assign to Lockheed all right, title, and interest in any inventions relating to Lockheed's business that might be made by me during my employment." Subsequently, Lockheed announced to its employees a plan for paying employee-inventors certain percentages of any income received by Lockheed as the result of its sale or licensing of employee inventions to third parties. Although Tom was assigned by Lockheed as a layout draftsman to design window installations and not to design new windshield construction, Tom conceived, invented, and perfected a new and different windshield construction to be used on aircraft. Tom assigned all his rights in the patented invention to Lockheed, which subsequently derived substantial royalties from three licensing agreements covering the invention. This year, Tom received, in addition to his salary, a royalty payment of $50,000 from Lockheed, which was paid out of royalties received by Lockheed pursuant to the above licensing agreements. How should Tom report the payment received under the plan?

Notes:

Hypothetical 9
Patent Transfer

Lisa, the inventor of an electronic device, applied for a patent and then granted to General Electric, a publicly trade company, the "sole and exclusive right, privilege and license to use, manufacture, produce and sell the invention covered by the patent application for a period of 20 years."

a. What is the proper tax treatment of the assignment assuming Lisa receives (1) a lump sum payment of $200,000, or (2) a percentage of the gross receipts realized by General Electric from the sale of the product? Would the answer be different if Lisa transferred the patent application to a corporation in which Lisa owned one-third of the outstanding stock? What if the transfer was to a corporation in which Lisa owned 80% or more of the outstanding stock?

b. Assume that General Electric purchased the invention from Lisa for a percentage of the gross receipts realized by General Electric from the sale of the product. Pursuant to the agreement, General Electric paid Lisa $20,000 in Year 1 and $40,000 in Year 2. At the beginning of Year 3, General Electric sold all substantial rights in the patent to an unrelated third party for $300,000. What is the amount of General Electric's gain on the sale? Will any gain be recaptured as ordinary income under section 1245? Does it matter?

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Hypothetical 10
Patent Transfer

Drew is a successful inventor who has been issued over 200 patents during his lifetime. His latest patented invention is an indicator light which permits the testing of an internal lighting circuit without the removal of a bulb. Drew agreed to transfer to Signal, Inc., an unrelated corporation, the exclusive right for the life of the patent to manufacture, use, and sell the indicator lights throughout the United States east of the Mississippi River in exchange for 10% of the gross selling price on sales made by Signal. How should Drew treat payments received by Signal each year? Would your answer change if Drew reserved (1) the right to act jointly with Signal in resisting infringement of the invention, and (2) the right to terminate the agreement if Signal failed to make and sell 1,000 indicator lights during any 6-month period?

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Hypothetical 11
Patent Transfer

David is the inventor of a patented leveling device for tables and chairs. In 2007, David entered into an agreement with American Seating Company whereby it was granted the right, for a period of five years, to make, use, and sell the leveling devices but only in the public seating field (furniture for schools, churches, courtrooms, theaters, and hospitals, but not furniture for restaurants and cafeterias) for a royalty of one cent on each device sold. In 2008, David entered into an agreement with Ever-Level, Inc, an unrelated corporation, whereby it was granted the right to make use, and sell leveling devices for the life of the patent, subject to the American Seating license, for a royalty of 7% of sales. Does section 1235 apply, even though non-exclusive rights in the patent are outstanding?

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Hypothetical 12
Patent Litigation

InvenCo enters into a license agreement with Licensee wherein InvenCo grants Licensee the exclusive right to use a patent for two years in connection with Licensee's manufacture and marketing of certain products covered by the patent. Licensee fails to pay royalty payments in breach of the license agreement, and InvenCo initiates a suit against Licensee. InvenCo incurs $50,000 in litigation costs. What is the tax treatment of the litigation costs?

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Hypothetical 13
Patent Litigation

InvenCo's marketing associates discover that Competitor is selling a new product that is infringing on InvenCo's patent. Upon further investigation, InvenCo initiates a suit against Competitor alleging Competitor's product is infringing on InvenCo's patent and such infringement is willful. In its complaint, InvenCo asks the court for attorneys' fees and treble damages. Competitor asserts that InvenCo's patent is invalid. InvenCo incurs $250,000 in litigation costs associating with Competitor's invalidity defense.

a. What is the tax treatment of InvenCo's $250,000 litigation costs?
b. Assume that the litigation proceeds to trial and the jury enters a verdict in favor of InvenCo. The jury found that Competitor had willfully infringed InvenCo's patent and awarded InvenCo damages in the amount of $1.0 million. What is the tax treatment of the award?
c. If InvenCo also received an award for attorneys' fees in the amount of $750,000, what is the tax treatment of the award for attorneys' fees?

Notes:

Hypothetical 14
Patent Litigation

Assume the facts of Problem 13. Competitor pays to InvenCo the $1.75 million judgment upon Competitor's exhaustion of all its appellate rights. In the year preceding the trial, Competitor purchased the entire business entity (BE) that was selling and marketing the infringing product. Competitor and BE negotiated the purchase price and allocated $200,000 for InvenCo's pending litigation. BE represented that InvenCo's suit was meritless, and in the worst case scenario the suit would cost $500,000. Competitor's attorneys concurred with BE's representation. Now, after paying the $1.75 million judgment to InvenCo, Competitor would like to deduct the total amount in the year it incurs. What is the tax treatment of the judgment amount?

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Hypothetical 15
Patent Donation to Charity

BioPharm, Inc. is a biopharmarceutical company that holds a very large patent portfolio. Like many of its competitors, BioPharm possesses more patents than it needs for its monopolistic present and future pipe drugs, and has no desire to devote part of its budget to pay costs associated with the maintenance of unused patents. To enhance its corporate image, given the negative spotlights on numerous corporate scandals in the media, BioPharm wants to donate a number of patents to educational and research institutions to further their basic, fundamental and pure scientific investigation. However, the company also wants tax deductions for its intellectual property donations. Will BioPharm be entitled to any charitable tax deductions?

Notes:

I. Taxation of Patent Development

A. I.R.C. § 41. In January 2004, after considering comments received and statements made at a public hearing, the Treasury issued final regulations under § 41. T.D. 9104, 69 Fed. Reg. 22-01 (Jan. 2, 2004). The final regulations are effective for taxable years ending on or after December 31, 2003. Treas. Reg. § 1.41-4(e). For taxable years ending before December 31, 2003, the IRS will not challenge tax return positions consistent with these final regulations. Preamble, 69 Fed. Reg. 22, 26. These final regulations generally retain the provisions of the December 2001 proposed regulations, but clarify the provisions relating to the "process of experimentation" requirement in § 41(d)(1)©. It should be noted that the final regulations do not contain final rules for research with respect to internal use software for purposes of § 41(d)(4)(E). Preamble, 69 Fed. Reg. 22. As a result, taxpayers can rely on the prior suspended regulations (issued in January 2001) or the proposed regulations (issued in December 2001) for research with respect to internal use software until final regulations are issued governing internal use software.

1. The "Discovery Test." Prior to issuance of the final regulations in 2004, the controversial "discovery test," or some form of it, had been used frequently by the IRS and several courts to disallow research credits, even though it was based on a strained interpretation of the statutory language of § 41(d) and lacked support in the legislative history. *See* United Stationers Inc. v. U.S., 982 F. Supp. 1279 (N.D. Ill. 1997), *aff'd* 163 F.3d 440 (7th Cir. 1998). For more recent cases, see Tax and Accounting Software Corp. v. U.S., 301 F.3d 1254 (10th Cir. 2002) (holding that there is an independent discovery requirement (test) in the multi-part test for research credit eligibility that must be satisfied before expenses can qualify for the research credit); Wicor, Inc. v. U.S., 116 F. Supp.2d 1028 (E.D. Wis. 2000), *aff'd* 263 F.3d 659 (7th Cir. 2001); Norwest Corp. and Subsidiaries v. Commissioner, 110 T.C. 454 (1998). In a welcomed development, the final regulations issued in 2004 put to rest the controversial "discovery test" and eliminated the requirement that qualified research be undertaken to "obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science of engineering" Preamble, 66 Fed. Reg. 66363. Instead, the final regulations repeat the requirement from Treas. Reg. § 1.174-2(a)(1) by stating that research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. *Id*. According to Treas. Reg. § 1.174-2(a)(1), "uncertainty" exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. As stated in the Preamble, "there should be no 'discovery' requirement in the research credit regulations separate and apart from that already required under § 1.174-2(a)(1)." Preamble, 66 Fed. Reg. 66363.

2. Patent Safe Harbor. As under the prior suspended regulations, the final regulations provide a patent safe harbor, under which the issuance of a patent is conclusive evidence that a taxpayer has discovered information that is technological in nature and is intended to eliminate uncertainty concerning the development or improvement of a business component. Treas. Reg. § 1.41-4(a)(3)(iii). The patent safe

harbor has not been extended to encompass the process of experimentation requirement, discussed below. Accordingly, some commentators have questioned what purpose the patent safe harbor serves given that the regulations abandon the discovery test. *See* Christopher J. Ohmes, David S. Hudson, & Monique J. Migneault, *Final Research Credit Regulations Expected to Immediately Affect IRS Examinations*, TAX NOTES, Feb. 23, 2004, at 1015, 1018.

3. "Process of Experimentation." The final regulations issued in 2004 provide that "a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities." Treas. Reg. § 1.41-4(a)(5). In contrast to the prior suspended regulations, the final regulations provide that activities to establish the appropriate design of a business component may qualify for the credit. *Id*. The final regulations set out the core elements of a process of experimentation for purposes of the research credit:

> a. A taxpayer is required to identify the uncertainty regarding the development or improvement of a business component that is the object of the taxpayer's research activities.
> b. A taxpayer is required to identify one or more alternatives intended to eliminate that uncertainty.
> c. A taxpayer is required to identify and conduct a process of evaluating the alternatives (e.g., modeling, simulation, or systematic trial and error).
>
> As continues to be clear, the requirements for a process of experimentation under § 41 continue to be more stringent than the requirements for research and development in the experimental or laboratory sense under § 174. Indeed, the final regulations state that the mere existence of uncertainty regarding the development or improvement of a business component does not indicate that all of a taxpayer's activities undertaken to achieve the new or improved business component constitute a "process of experimentation," even if the taxpayer does achieve the new or improved business component. Treas. Reg. § 1.41-4(a)(5)(I). And, as stated in the Preamble, "merely demonstrating that uncertainty has been eliminated (e.g., the achievement of the appropriate design of a business component when such design was uncertain as of the beginning of a taxpayer's activities) is insufficient to satisfy the process of experimentation requirement. A taxpayer bears the burden of demonstrating that its research activities additionally satisfy the process of experimentation requirement." Preamble, 69 Fed. Reg. 22, 24.

4. The "Substantially All" Requirement. As with the prior suspended regulations, the final regulations issued in 2004 provide that the "substantially all" requirement is satisfied only if 80 percent or more of the research activities, measured on a cost or other consistent reasonable basis, constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability or quality of a business component. Treas. Reg. § 1.41-4(a)(6). The final regulations clarify that the

"substantially all" requirement can be satisfied even if some portion of a taxpayer's activities are not for a qualified purpose (e.g., relating to style, taste, cosmetic, or seasonal design factors). *See id*.; *see also id.* § 1.41-4(a)(8), Example 4.

5. Section 41 Versus Section 174. It might be possible for research expenses to qualify for the credit under § 41 as well as the deduction under § 174. In such a case, to the extent a credit is taken under § 41, deductions under § 174 must be reduced pursuant to § 280C. I.R.C. § 280C(c)(1). Even if deductions are not taken under § 174, but rather are capitalized, the amount capitalized must be reduced by the amount of any research credit under § 41. I.R.C. § 280C(c)(2). It should be noted that a taxpayer can elect to claim a reduced research credit under § 41 and thereby avoid a reduction of the § 174 deduction. I.R.C. § 280C(c)(3). The IRS and Treasury have requested public comment on regulations relating to the manner of making this election under § 280C(c)(3). 69 Fed. Reg. 21600-21601 (Apr. 21, 2004).

6. Note on Computation of the Credit. The *general research credit* is incremental in that it is equal to a certain percentage of qualified research spending above a base amount, which can be thought of as a firm's normal level of research and development investment. I.R.C. § 41(a)(1). As an alternative to using the incremental research credit, a taxpayer may elect to use the *alternative incremental research credit*. The alternative incremental research credit does not rely on a research intensity ratio, but instead is based on the extent to which current year research expenses exceed certain percentages of the taxpayer's average annual gross receipts for the four taxable years preceding the current year. I.R.C. § 41(c)(4). For taxable years ending after December 31, 2006, taxpayers may, at their election, compute the research credit under a third method–the *alternative simplified credit method*–in lieu of the regular credit or the alternative incremental credit. The alternative simplified credit is an amount equal to 12% of the amount by which the qualified research expenses exceed 50% of the average qualified research expenses for the three preceding taxable years. I.R.C. § 41(c)(5). [NOTE: FOR TAX YEARS BEGINNING AFTER DECEMBER 31, 2008, THE ALTERNATIVE INCREMENTAL METHOD CAN NO LONGER BE ELECTED. I.R.C. § 41(h)(2), as redesignated and added by the Emergency Economic Act of 2008. ALSO, FOR TAX YEARS BEGINNING AFTER DECEMBER 31, 2008, THE PERCENTAGE USED TO COMPUTE THE ALTERNATIVE SIMPLIFIED CREDIT IS INCREASED TO 14%. I.R.C. § 41(c)(5), as amended by the Emergency Economic Act of 2008.]

7. Note on Temporary Nature of the Credit. The section 41 research credit has been continually renewed as a temporary provision. It actually expired on December 31, 2007, but has been extended for two years or through December 31, 2009. I.R.C. § 41(h)(1)(B), as amended by the emergency Economic Stabilization Act of 2008.

B. I.R.C. § 59. On July 19, 2004, the Service published proposed regulations on the optional 10-year write-off of research and experimental expenditures. Prop. Reg. § 1.59-1, at 69 Fed. Reg. 43367-43369 (July 19, 2004). Effective for tax years ending on or after July 20, 2004, the regulations provide guidance for making and revoking elections under § 59(e). Many commentators have criticized the proposed regulations for imposing onerous documentation requirements.

C. I.R.C. § 174. The Tax Court recently addressed whether research and development expenditures incurred by a computer software developer were incurred in a trade or business and, thus, deductible under § 174. In *Saykally v. Commissioner,* T.C. Memo 2003-152, the taxpayer, who had extensive technical expertise in the computer software industry, entered into an agreement with his wholly-owned corporation, which was engaged in the marketing of software products. Under the agreement, the taxpayer would create and own developed technology and would license the developed technology to his wholly owned corporation in exchange for royalties. The corporation would market the developed technology to its customers. The taxpayer deducted his research and development expenditures on his tax return. The IRS disallowed the deductions on the ground that they were not incurred in a trade or business. The Tax Court held that the software developer was not entitled to current deductions under § 174. According to the court, the taxpayer did not intend to market the developed technology himself, but rather intended to market the technology through his wholly-owned corporation. The taxpayer did not have the objective intent to enter into a future business of his own with the developed technology. Rather, the taxpayer's purpose for engaging in the software development was to create the developed technology that could be licensed to the corporation for use in the corporation's existing business. In other words, the taxpayer's research and development activities amounted to nothing more than the development of property rights that he intended to license to another company for use in that company's trade or business. The Ninth Circuit, in an unpublished per curiam decision, recently affirmed the Tax Court's decision that denied the § 174 deductions. No. 05-75128 (Sept. 7, 2007), available at 2007 TNT 175-47.

D. I.R.C. § 263. In January 2004, the Service issued final regulations under § 263 that provide comprehensive rules for capitalization of amounts paid to acquire or create intangible assets. *See* T.D. 9107, 68 FR 436-01. The final regulations adopt with some minor revisions the proposed regulations that were issued in December 2002. The final regulations apply to amounts paid or incurred on or after December 31, 2003. Treas. Reg. § 1.263(a)-4(o).

II. Taxation of Patent Acquisitions

A. I.R.C. § 197. In Private Letter Ruling 200416002, the taxpayer purchased two patents from a seller, along with certain associated trademarks. The taxpayer represented that it would have paid the same amount for the patents regardless of whether or not the associated trademarks were transferred with the patents in the transaction. Further, no price was separately negotiated for the trademarks associated with the patents. The Service ruled that the purchase of the patents and the trademarks did not constitute the acquisition of a trade or business and, therefore, the patents and the trademarks did not constitute § 197 intangibles.

III. Taxation of Patent Transfers

A. Taxability of Patent Royalties. A claim for more royalties from a licensee has no bearing on the taxability of royalties actually received. *See Poindexter v. Commissioner*, T.C. Memo 2005-122 (holding that a licensor's claim that he should have received more royalties (i.e., claim that he was not paid the full royalties owed by a licensee) has no bearing on determining the licensor's correct tax liability and his obligation to pay that liability.

B. I.R.C. § 1031. In Technical Advice Memorandum 200602034 (Sept. 29, 2005), the IRS provided guidance on intellectual property exchanges. The IRS ruled that intellectual property used predominantly in the United States and intellectual property used predominantly outside the United States are not "like-kind" property for purposes of nonrecognition treatment under § 1031. For two patents to be considered of like kind, the IRS ruled that the underlying property must be either of the same General Asset Class under Treas. Reg. § 1.1031(a)-2(b)(2) or the same Product Class of § 1.1031(a)-2(b)(3) or otherwise of like kind. The IRS applied the same analysis to unregistered intellectual property (i.e., designs and drawings, trade secrets and secret know-how). The IRS also ruled that trademarks and trade names should never be considered like-kind because trademarks and trade names are unique and so closely related to (if not part of) the goodwill and going concern value of a business.

C. I.R.C. § 1235. The Internal Revenue Service has recently issued several administrative pronouncements dealing with Section 1235 of the Internal Revenue Code:

1. Employee Transfers. In a recent Technical Advice Memorandum, the IRS applied *McClain* and *Chilton* in concluding that a university professor was entitled to capital gains treatment under § 1235 for royalties received from the university. In Tech. Adv. Mem. 200249002 (Aug. 8, 2002), a university professor developed an invention in the course of his research. He filed patent applications for the invention and then executed an assignment agreement, assigning his interest in the patent applications to the university. The professor also entered into a royalty distribution agreement with the university regarding the invention, which provided the professor would receive a certain percentage of the royalties resulting from the university's licensing of the patents. The university treated these amounts as royalty payments and not as part of the professor's salary. In the TAM, the Service looked to the facts and circumstances of the employment relationship and concluded that the payments in question were connected to the transfer of invention rights, rather than compensation for services. Among the factors considered in favor of the professor were: (1) The payments received for the rights to the invention were in addition to and separate from the professor's salary, pursuant to a separate agreement with the university; (2) continued receipt of the payments was not contingent on continued employment with the university, (3) the amount of the payments received was dependent on the use or value of the licensing of the patent, and (4) the university treated the payments as royalties, not as salary.

2. "Holder" Status. In 2005, the Service issued three private letter rulings holding that an inventor who filed patents with two co-inventors and formed a limited liability company (LLC) with them retained his status as a "holder" for purposes of §1235, and that any gain recognized by the LLC on disposition of the patent rights would be qualified for treatment as preferential long-term capital gain to the members. Priv. Ltr. Rul. 200506008; Priv. Ltr. Rul. 200506009; Priv. Ltr. Rul. 200506019. In these rulings, three inventors (A, B, and C) filed several patent applications relating to a certain product. In a tax-free transaction, they transferred their respective interests in the product (including all of their interest in the patents and trade secrets, know-how, and other

intellectual property associated with the product) to a newly formed LLC (treated as a partnership for tax purposes) in exchange for membership interests in the LLC. In response to a ruling request by Investor A, the Service concluded: (1) following the transfer of A's interests in the patents to the LLC, A will retain A's status as a "holder" for § 1235 purposes; and (2) provided the other requirements of section 1235 were satisfied, A's allocable shares of gain recognized by the LLC on a disposition of an interest in the patents would qualify under § 1235 as long-term capital gain.

D. Charitable Donations of Patents. On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 ("the 2004 Act"). The 2004 Act is intended to curb improper deductions resulting from overvaluation, while continuing to encourage donations of intellectual property to qualified charities. The new legislation applies to all forms of intellectual property, including patents, certain copyrights, trademarks, trade names, trade secrets and know-how, certain software, or similar intellectual property or applications or registrations of such property. The new legislation does not apply to self-created copyrights or off-the-shelf computer software.

1. Initial Tax Deduction. The 2004 Act limits the amount of the charitable deduction to the lesser of the taxpayer's basis in the donated intellectual property or the fair market value of the intellectual property at the time of the contribution. I.R.C. § 170(e)(1)(B). In most cases, the lesser amount would be the donor's basis.

2. Future Tax Deductions. Although the 2004 Act lowers the initial charitable deduction, it permits a donor to take additional charitable deductions in later years based on a certain percentage of the donee's income attributable to the intellectual property. More specifically, a donor is allowed additional deductions in later years based on a specified percentage of the "qualified donee income" received or accrued by the charity from the donated property itself, rather than income stemming from the activity in which the donated property is used. I.R.C. § 170(m)(3). "Qualified donee income" is the net income that is properly allocable to "qualified intellectual property." For purposes of these future deductions, "qualified intellectual property" does not include intellectual property donated to a private foundation. I.R.C. § 170(m)(9).

The amount of the additional deduction a taxpayer may take each year is determined using a sliding-scale percentage of qualified donee income received or accrued by the charity that is allocable to the property. I.R.C. § 170(m)(1), (7). As illustrated below, the percentage decreases each year over a twelve-year period. In the first and second years after the contribution, a taxpayer can deduct 100% of the qualified donee income. In year three, a taxpayer may deduct 90% of the qualified donee income. In year ten, only 20% of the qualified donee income is deductible. The following chart shows the actual sliding scale:

Taxable Year of Donor Ending on or After Date of Contribution	Applicable Percentage
1st	100
2nd	100

3rd	90
4th	80
5th	70
6th	60
7th	50
8th	40
9th	30
10th	20
11th	10
12th	10

3. Impact of New Law. By eliminating the fair market value standard for contributions of intellectual property, the 2004 Act will reduce the number of negligent and intentional overvaluations of intellectual property donations and, correspondingly, will reduce the administrative costs and burdens associated with overvaluations of donated intellectual property. By eliminating a fair market value approach, however, the 2004 Act has eliminated the immediate economic incentive for charitable giving of intellectual property. Without this immediate economic incentive, according to some commentators, donations of intellectual property will decrease dramatically.