Intellectual Property Taxation
Franklin Pierce Law Center
Summer 2003
Final Exam

Instructions

You will have two (2) hours to complete this exam. Write all your answers in the space provided. If you need more room, you may write on the back of the page or on the blank pages at the end of the exam.

During the exam, you may consult your assigned textbook, statute and regulations book, class notes and/or outline, and any handouts I have given you. Do not consult with any person during the exam, and do not consult any unauthorized materials such as commercial outlines. You may use a calculator.

You will receive credit for any issues that you correctly identify, and for any analytical steps that you perform correctly. It is possible to pass the exam without completing it. Partial credit will be given for answers that are partially correct. Be sure to explain your reasoning and show your work. If additional facts would be helpful in your analysis, explain how they would help you.

When asked about the tax consequences of an event, you should identify any income, loss, deduction(s), or effect on basis that results from that event, and indicate whether the character of the income or loss is capital or ordinary. If capital, is it long-term or short-term (or are the facts insufficient to determine this)? Where basis is created, indicate whether that basis is subject to depreciation (or amortization) deductions. In the case of depreciable or amortizable assets, you may assume that the salvage value equals zero.

Question One

DippinDots, Inc., is a Delaware corporation engaged in the business of selling a patented ice cream product. DippinDots has registered several trademarks – including "DippinDots" and "The Ice Cream of the Future" -- in the United States and many other countries throughout the world. DippinDots has franchised its ice cream business throughout the United States, Europe, and South America. DippinDots' operations in the U.S. are extremely successful, and it has also achieved a modest success in South America and Europe. Although it has not yet opened any outlets in Asia or Africa, DippinDots has taken advantage of the liberal trademark registration laws in many Asian and African nations to register its trademarks in those countries in order to secure its rights to those marks in anticipation of expanding its operations to those countries in the future. DippinDots has also obtained product and process patents for its ice cream product and manufacturing process in all the countries where it has registered its trademarks.

DippinDots, Inc. agrees to sell all of its worldwide intellectual property rights and franchising operations to Ben and Jerry's, Inc. for $200 million in cash. In preparing its tax return for the year of the sale, DippinDots makes the following allocation of the selling price:

U.S. patents	$ 1 million
U.S. trademark rights	$ 1 million
U.S. good will	$ 20 million

Foreign patents	$ 9 million
Foreign trademark rights	$ 4 million
Foreign good will	$ 165 million

After examining this tax return, the IRS proposes a different allocation:

U.S. patents	$ 1 million
U.S. trademark rights	$ 20 million
U.S. good will	$ 1 million

Foreign patents	$ 9 million
Foreign trademark rights	$ 165 million
Foreign good will	$ 4 million

a) What is the most likely reason that the IRS would make such a substantial change in the allocation of the selling price of DippinDots' foreign assets? Which allocation is the most persuasive, as a matter of law? Explain thoroughly.

b) If the parties had allocated a part of the selling price to a covenant not to compete in the territories which DippinDots sold to Ben & Jerry's, what would be the tax effect (on DippinDots) of that allocation?

c) Suppose that DippinDots had been willing to sell its foreign operations for a 5% annual royalty rather than cash. Under the allocation proposed by the IRS, how would DippinDots' tax consequences differ, compared to the sale for cash? Explain thoroughly.

Question Two

Wally Entertainment Group, Inc., pays Dead Duck Films $20 million to acquire all of the rights to *The Little Mummy*, an animated children's film, for the entire term of its copyright. Wally then releases *The Little Mummy* through Bella Vista Films, an unrelated company that specializes in film distribution. Wally initially estimates that, after subtracting Bella Vista's distribution costs and fees, Wally will net about $200 million in the first ten years of *The Little Mummy*'s useful life. You should assume that the IRS will agree that the useful life of a film of this type, if measured in years, is 7 years. If salvage value is relevant to your analysis, you may assume that the film's salvage value is zero.

(1) If the film's distribution costs and fees in Year 1 of its exploitation exceed the gross receipts received by Bella Vista, what amortization method should Wally utilize for the entire useful life of this film, and why?

(2) Suppose instead that the film's gross receipts are $170 million in the first year of exploitation, and Bella Vista's distribution fees and expenses are $50 million. Assuming that, by the end of Year 1, Bella Vista has disbursed to Wally all of the net revenues to which Wally is entitled under their contract, what amortization method should Wally choose for the entire useful life of this film, and why?

(3) Using the amortization method that you believe is the most favorable to Wally, and assuming that *The Little Mummy* will generate $200 million in net revenues to Wally during the first 10 years of its useful life, calculate Wally's amortization deductions during the first 4 years of the film's exploitation, using the following figures:

	Yr. 1	Yr. 2	Yr. 3	Yr. 4
Gross receipts	170 million	100 million	20 million	10 million
Bella Vista's fees & costs	50 million	40 million	10 million	3 million
Wally's net revenues	120 million	60 million	10 million	(7 million) loss

(4) Using the same information as in (3), assume that, immediately after the end of Year 2, Wally sells *The Little Mummy*. Explain, as thoroughly as you can, Wally's tax consequences from this sale if it:

a) sells the film for a lump sum of $ 40 million.

b) sells the film for a lump sum of $ 1 million.

(5) Using the same information as in (3), assume that instead of acquiring just *The Little Mummy,* Wally had instead acquired this film along with the rest of the film inventory of Dead Duck Films when the owner of Dead Duck had to sell off all the company's assets in order to pay off his divorce settlement. Assume that Dead Duck had no significant assets other than its film inventory. Out of the total purchase price of $400 million for Dead Duck's film inventory, assume that the portion of the total purchase price that is allocable to *The Little Mummy* is $20 million.

a. Does this information change the amortization deductions you calculated in (3)? Explain thoroughly.

b. On these same facts, assume Producer sells *The Little Mummy* immediately after the end of Year 2. Explain, as thoroughly as you can, Wally's tax consequences from this sale if it:

i. Sells the film for a lump sum of $ 40 million.

ii. Sells the film for a lump sum of $ 1 million.

Question Three

Brazilian citizen and recording artist Jorge Miguel negotiates a new record contract with Def Jelly Records, a U.S. record company based in Los Angeles. Under the contract, his only compensation will consist of royalties from sales and certain licenses of his recordings. In the first year of the contract, Jorge travels to the U.S., records a new CD at Def Jelly's recording studio in Hollywood, and then returns to his home country, Brazil. During the next year, he receives $ 5 million dollars in royalties from Def Jelly's worldwide sales of his new CD. Of this amount, $1 million comes from CD sales in the

U.S., $ 3 million from sales in Brazil, and $ 1 million from sales in other countries throughout the world.

a) How much of this $ 5 million is U.S. sourced, and why?

b) In the absence of a tax treaty between Brazil and the U.S., what are Jorge's U.S. tax consequences?

c) If there is a tax treaty between Brazil and the U.S. which taxes royalties from the sale or use of intellectual property at the rate of 5%, what are Jorge's tax consequences?

d) If he is required to file a U.S. tax return, how should Jorge calculate his foreign tax credit under section 904?