## Intellectual Property Taxation

Carolina Academic Press Law Casebook Series Advisory Board

**(3**)

Gary J. Simson, Chairman Cornell Law School

Raj K. Bhala University of Kansas School of Law

John C. Coffee, Jr. Columbia University School of Law

Randall Coyne University of Oklahoma Law Center

John S. Dzienkowski University of Texas School of Law

Paul Finkelman University of Tulsa College of Law

Robert M. Jarvis Shepard Broad Law Center Nova Southeastern University

Vincent R. Johnson St. Mary's University School of Law

Michael A. Olivas University of Houston Law Center

Kenneth Port William Mitchell College of Law

Michael P. Scharf Case Western Reserve University Law School

Peter M. Shane H. J. Heinz III School of Public Policy and Management Carnegie Mellon University

> Emily L. Sherwin University of San Diego School of Law

John F. Sutton, Jr.
Emeritus, University of Texas School of Law

David B. Wexler University of Arizona College of Law

# **Intellectual Property Taxation**

### **Problems and Materials**

Jeffrey A. Maine Xuan-Thao Nguyen

CAROLINA ACADEMIC PRESS

Durham, North Carolina

Copyright © 2004 Jeffrey A. Maine and Xuan-Thao N. Nguyen All Rights Reserved

ISBN 0-89089-431-0 LCCN 2003106098

#### CAROLINA ACADEMIC PRESS

700 Kent Street Durham, North Carolina 27701 Telephone (919) 489-7486 Fax (919) 493-5668 www.cap-press.com

Printed in the United States of America

## **Contents**

Chapter 1. Introduction	3
Case Example	4
Chapter 2. Overview of Intellectual Property	7
I. Assignment for Chapter 2	7
II. Problems for Chapter 2	7
III. Overview	8
A. Patents	8
Types of Patents	12
B. Trade Secrets	13
C. Copyrights	15
D. Trademarks, Trade Names, and Trade Dress	16
E. Domain Names	18
F. Computer Software	19
IV. Materials	20
Diamond v. Chakrabarty	20
Feist Publications, Inc. v. Rural Telephone Service Co.	22
Community for Creative Non-Violence v. Reid	24
Holtzbrinck Publishing Holdings v. Vyne Communications	26
Data General Corp. v. Grumman Systems Support Corp.	32
Two Pesos, Inc. v. Taco Cabana, Inc.	39
Interstellar Starship Services, Ltd. v. Tchou	41
Chapter 3. Overview of Federal Income Taxation	51
I. Assignment for Chapter 3	51
II. Problems for Chapter 3	51
III. Overview	53
A. Structure of the Federal Income Tax System	54
1. Gross Income	54
2. Deductions	57
3. Tax Rates	60
4. Tax Credits	64
B. Researching Federal Tax Law	64
1. The Internal Revenue Code	64
2. Treasury Regulations	65
3. IRS Rulings and Procedures	66
(a) Revenue Rulings	66

(b) Private Letter Rulings	66
(c) Revenue Procedures	67
4. Case Law	67
5. Legislative History	68
IV. Materials	68
Commissioner v. Groetzinger	68
Welch v. Helvering	72
Commissioner v. Lincoln Savings & Loan Ass'n	74
INDOPCO, Inc. v. Commissioner	79
Waterman v. Mackenzie	84
Burnet v. Logan	85
Williams v. McGowan	87
Raytheon Production Corp. v. Commissioner	89
Chapter 4. Taxation of Intellectual Property Development	91
I. Assignment for Chapter 4	91
II. Problems for Chapter 4	91
III. Overview	93
A. Deductibility Under §162—Ordinary and Necessary Business Expenses	93
1. The "Expense" Requirement	94
(a) Section 263(a): Capital Expenditures	94
(b) Section 263A: Direct and Indirect Expenditures Incurred to	0.0
Produce Tangible Property	96
2. The "Ordinary and Necessary" Requirement	97 97
3. The "In Carrying on a Trade or Business" Requirement	97 99
B. Deductibility Under §174—Research and Experimental Expenditures  1. Research and Experimental Expenditures	99
2. Disqualified Expenditures	100
3. "In Connection with a Trade or Business" Requirement	101
4. Reasonableness of Expenditures	103
5. The Election to Expense or Amortize	103
(a) Current Expense Method	103
(b) Deferred Expense (Amortization) Method	103
C. Alternative Minimum Tax Considerations	104
D. Amortization of Capitalized Intellectual Property Development Costs	105
E. The §41 Research and Development Credit	106
1. "Qualified Research" Defined	106
(a) Discovery Test	106
(b) Process of Experimentation	107
2. Activities Excluded from "Qualified Research"	108
(a) Research After Commercial Production	108
(b) Internal-Use Computer Software	109
IV. Materials	110
RJR Nabisco, Inc. v. Commissioner	110
Action on Decision	116
Technical Advice Memorandum 9643003	117
I.R.S. Notice 88-62	121
Vitale v. Commissioner	126
Field Service Advice 200125019	135

CONTENTS	vii
Snow v. Commissioner	141
Green v. Commissioner	143
Revenue Procedure 2000-50	148
Revenue 110ccdure 2000 30	110
Chapter 5. Taxation of Intellectual Property Acquisitions	151
I. Assignment for Chapter 5	151
II. Problems for Chapter 5	151
III. Overview	153
A. Purchase Costs	153
1. Amortization Under §197	154
(a) General Rule	154
(b) Exceptions for Certain Intellectual Property	154
(c) Computing the §197 Deduction	156
2. Amortization Under §167	157
(a) General Rule	157
(b) Computing the \$167 Deduction	157
B. Licensing of Intellectual Property	160
1. Licenses Acquired as Part of a Trade or Business	160
2. Licenses Not Acquired As Part of a Trade or Business	161
C. Income from Holding Intellectual Property	161
IV. Materials	162
Revenue Ruling 71-177	162
Revenue Ruling 60-358	163
Revenue Ruling 79-285	164
Greene v. Commissioner	167
Associated Patentees, Inc. v. Commissioner	171
Revenue Ruling 67-136	175
Private Letter Ruling 200137013	176
Chapter 6. Taxation of Intellectual Property Transfers	181
I. Assignment for Chapter 6	181
II. Problems for Chapter 6	181
III. Overview	183
A. Sales of Intellectual Property	185
1. General Characterization Provisions	186
(a) The Sale or Exchange Requirement	187
(b) The Definition of Capital Asset	187
(c) Holding Period	189
2. Special Characterization Provisions	189
(a) Section 1231: Quasi-Capital Assets	189
(b) Section 1235: Transfers of All Substantial Rights to Patents	190
(c) Sections 1239 and 707(b) Ordinary Income	193
(d) Section 1245 Recapture	194
(e) Section 1253 Transfers	195
3. Contingent Payment Sales	195
B. Licenses of Intellectual Property	197
C. Transfers to Business Entities	197
D. Transfers to Charitable Organizations	199

viii CONTENTS

IV. Materials	200
Watson v. Commissioner	200
Revenue Ruling 60-226	202
Stern v. United States	203
Levy v. Commissioner	208
Chilton v. Commissioner	210
Kueneman v. Commissioner	217
E.I. du Pont de Nemours & Co. v. United States	224
Revenue Ruling 78-328	228
Newton Insert Co. v. Commissioner	229
Stokely USA, Inc. v. Commissioner	236
Chapter 7. IP Holding Companies and R&D Limited Partnerships	243
I. Assignment for Chapter 7	243
II. Problems for Chapter 7	243
III. Overview	244
A. Intellectual Property (IP) Holding Companies	245
<ol> <li>Formation of IP Holding Companies</li> </ol>	246
(a) Tax Treatment of Parent Company	246
(b) Tax Treatment of IP Holding Company	247
2. Transfer-License Back Intellectual Property Arrangements	247
(a) Tax Treatment of IP Holding Company	248
(b) Tax Treatment of the Parent Company	249
3. Dividend Distributions to Parent Company	251
4. Liquidations of IP Holding Companies into Parent Companies	252
(a) Tax Treatment of the Parent Company	252
(b) Tax Treatment of the IP Holding Company	252
B. Research and Development (R&D) Limited Partnerships	253
<ol> <li>Formation of R&amp;D Limited Partnerships</li> </ol>	255
(a) Partner-Level Consequences	255
(b) Partnership-Level Consequences	256
2. Operation of R&D Limited Partnerships	256
(a) Basic Structure of Partnership Taxation	256
(b) Non-Liquidating Distributions of Cash and Property to	
Partners	257
3. Liquidation of R&D Limited Partnerships	258
IV. Materials	258
Delaware State Statute (Del. Code Ann. tit. 30, § 1902)	258
Vermont State Statute (Vt. Stat. Ann. tit. 32, § 5837)	259
Massachusetts State Statute (M.G.L.A. 62C, § 3A)	259
Geoffrey, Inc. v. South Carolina Tax Commission	260
Acme Royalty Co. v. Director of Revenue	264
SYL v. Comptroller of the Treasury	271
Syms Corp. v. Commissioner of Revenue	275
In re Sherwin-Williams Co.	279
Sherwin-Williams C. v. Commissioner	283
Department of Taxes, State of Vermont	290
Harris v. Commissioner	292
Scaggins v. Commissioner	208

CONTENTS ix

Chapter 8. Taxation of Intellectual Property Litigation	305
I. Assignment for Chapter 8	305
II. Problems for Chapter 8	305
III. Overview	307
A. Tax Treatment of Intellectual Property Litigation Costs	307
1. Litigation Costs in Patent and Copyright Cases	308
2. Litigation Costs in Trademark Cases	309
(a) Litigation Costs Incurred in Trademark Infringement Cases	309
(b) Litigation Costs Incurred in Unfair Competition Claims	309
B. Tax Treatment of Damage Awards and Settlement Proceeds in	
Intellectual Property Suits	310
1. Damage Awards or Settlement Proceeds in Patent/Copyright Cases	310
2. Damage Awards/Settlement Proceeds in Trademark Cases	311
3. Tax Treatment of Awards of Attorneys' Fees and Costs	311
C. Tax Treatment of Payments of Acquiring Intellectual Property Liability	312
IV. Materials	312
Safety Tube Corp. v. Commissioner	312
Urquhart v. Commissioner	314
Danskin, Inc. v. Commissioner	317
Georator Corp. v. United States	318
Rust-Oleum Corp. v. United States	320
Big Four Industries, Inc. v. Commissioner	325
Mathey v. Commissioner	326
Inco Electroenergy Corp. v. Commissioner	329
Illinois Tool Works v. Commissioner	334
Field Service Advisory 199925012	339
Chapter 9. Taxation of International IP Transactions and	
Cost Sharing Arrangements	345
I. Assignment for Chapter 9	345
II. Problems for Chapter 9	345
III. Overview	347
A. Outbound Transactions	348
1. General Taxing Rules	348
(a) Foreign Business Operations Conducted Directly by	
U.S. Persons	348
(b) Foreign Business Operations Conducted Indirectly	348
2. The Foreign Tax Credit	350
B. Inbound Transactions	351
1. General Taxing Rules	351
2. Taxation of Business Income	351
(a) In General	351
(b) Treaty Exceptions	352
3. Taxation of Non-Business Income from U.S. Sources	353
(a) "Fixed or Determinable, Annual or Periodical" Income	353
(b) Treaty Exceptions	353
C. Source Rules	354
1. Income Source Rules	354
(a) Personal Services	354

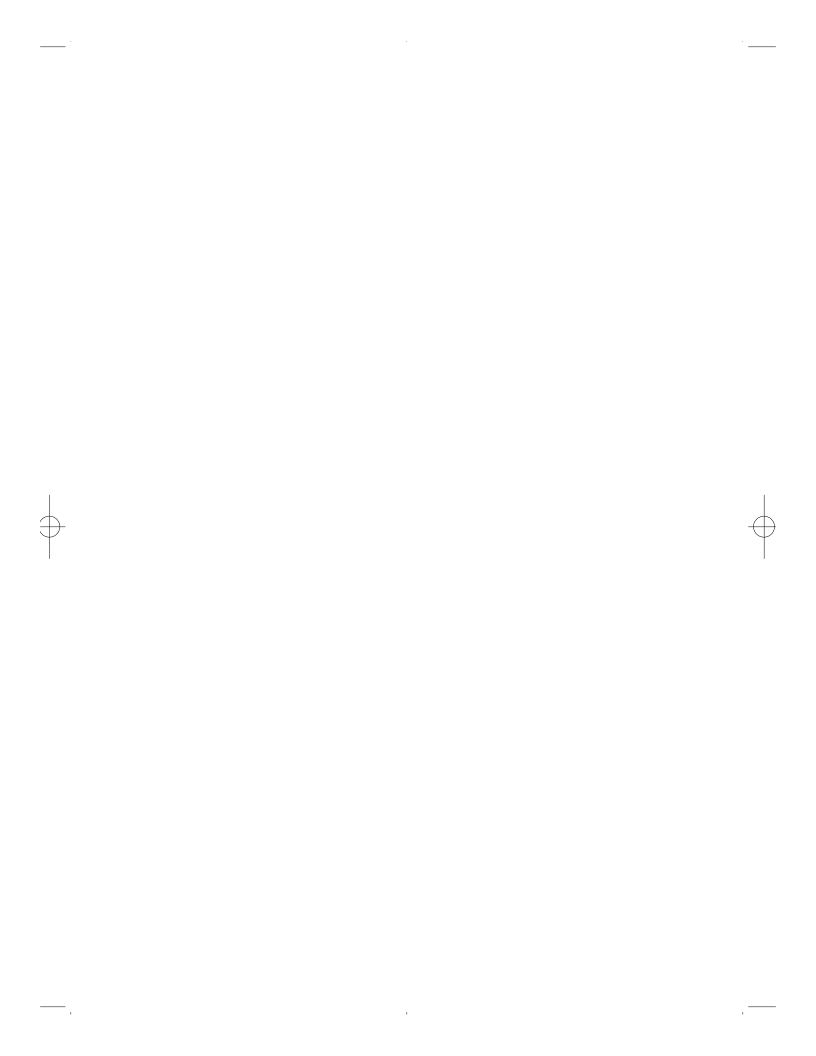
CONTENTS

(b) Royalties	354
(c) Sales	355
(d) Infringement Awards	356
2. Deduction Allocation and Apportionment Rules	356
(a) In General	356
(b) Research and Development Expenditures	356
D. The Role of Treaties	357
1. In General	357
2. The Relationship Between Treaties and the Code	357
E. Section 367(d): Transfers to Foreign Corporations	357
F. Section 482: International IP Transactions Between Related Parties	358
G. Cost Sharing Arrangements	359
1. Two or More Participants	360
(a) Reasonably Anticipated Benefits Requirement	360
(b) Accounting Requirements	361
(c) Administrative Requirements	361
2. Method for Calculating Each Participant's Share of Intellectual	
Property Development Costs	361
(a) Share of Intellectual Property Development Costs	361
(b) Share of Reasonably Anticipated Benefits	362
3. Periodic Adjustments	362
4. Documentation Requirements	363
5. Buy-in and Buy-out Payments for Intellectual Property Transfers	363
IV. Materials	364
Excerpt from The Joint Committee on Taxation, Description and	
Analysis of Present-Law Rules Relating to International Taxation	
(JCX-40-99), June 28, 1999	364
Boulez v. Commissioner	367
Revenue Ruling 68-443	372
Revenue Ruling 72-232	373
Revenue Ruling 80-362	374
SDI Netherlands B.V. v. Commissioner	375
International Multifoods Corp. v. Commissioner	380
Revenue Ruling 64-206	386
DHL v. Commissioner	388
Field Service Advice 200011021	398
Seagate Technology, Inc. v. Commissioner	409
Chapter 10. Internet/E-Commerce Taxation	415
I. Assignment for Chapter 10	415
II. Problems for Chapter 10	415
III. Overview	416
A. The Internet Nondiscrimination Act and The Internet Tax Freedom Act	417
1. No New Tax on Internet Service Access	417
2. No Multiple Taxes on Electronic Commerce Transactions	417
3. No Discriminatory Taxes on Electronic Commerce Transactions	418
B. State Taxation on Internet Sales	418
1. Substantial Nexus Standard—Offline Environment	419
2. Substantial Nexus—Internet Implications	419

CONTENTS	xi
CONTENTS	xi

3. States Sales Taxes on Electronic	
Commerce Transactions	420
IV. Materials	421
Internet Tax Freedom Act, 47 U.S.C. § 151	421
Quill v. North Dakota	425
NEW YORK ADVISORY OPINION, TSB-A-02(7)(S)	433
Wal-Mart Stores, Inc. v. City of Mobile	437
Andersen Consulting, LLP v. Comm'r of Revenue Services	439
NEW YORK ADVISORY OPINION, TSB-A-02(13)(S)	442
NEW YORK ADVISORY OPINION, TSB-A-02(3)(C)	444
NEW YORK ADVISORY OPINION, Pet. No. 5000510A	448
Charts of State Taxation of Online Transactions	
Chart A: Sales of Goods & Information	452
Chart B: Pre-packaged and Custom Software	462
Table of Cases	471
Table of Statutes and Administrative Material	479
Index	489

ij



## **Acknowledgments**

We wish to thank the students whom we have had the pleasure of teaching using these materials and Professors Mary LaFrance, Annette Nellen, David Andrade and other professors who adopted this book in their IP tax courses before it was in final form.

We are particularly indebted to Professor David Cameron of Northwestern University School of Law who provided perceptive comments and concrete suggestions to earlier versions of this book. Professor David Cameron and Professor Philip Postlewaite are pioneers in the field of taxation of intangible property, paving the way for new books and scholarship in IP taxation. We could not have completed the book without the contribution from Professor Anna Teller whose research and editorial assistance was invaluable. We thank Mr. Bruce Muck, Head Research Services at SMU Underwood Law Library for his research assistance.

We wish to express our gratitude to Professor Richard Gershon and Professor Jim Hambleton for providing us tremendous encouragement and support throughout the project. We also wish to thank Joy Gallagher for her patience and endless hours of revising the manuscript through its numerous drafts, keeping us organized, and putting up with our handwriting while incorporating changes. We thank Nancy Eagan for assisting us in the later revision of the book.

In addition to all of those students who labored on the book, special thanks are due to: Michelle Carlson, Jennifer Di Fonso, Cindy Fuqua, Robert Jemerson, Christina Jenkins, Stephen Jones, Kimberly Latham, and Mari Stewart.

Professor Maine would like to thank his mentors Professor Richard Gershon, Professor John (Jack) Miller, and Professor Meade Emory, whose constant support and guidance have led him into a fulfilling professional life. Professor Maine dedicates this book to his family and close friends who constantly remind him that there is more to life than IP tax.

Professor Nguyen also would like to thank Professor Danielle Jones-Conway, Professor Lateef Mtima and Professor Benjamin Davis for their suggestions and support. Professor Nguyen thanks her mentors Professor Hope Lewis, Professor David Hall, Professor John Flynn, Dean and Professor Gilbert Holmes, Maxim H. Waldbaum, Esq., and Lora A. Moffatt, Esq. for their guidance. Professor Nguyen dedicates this book to her soul mate and partner, Erik Darwin Hille and her son Khai-Leif Nguyen-Hille.

Finally, we extend our appreciation to Professors Martin Burke and Michael Friel for inspiring us to adopt their pedagogical approach. Writing this book was a joy for us. We could not believe that combining intellectual property and taxation for the first casebook was a stimulating, challenging, and satisfying experience. We hope that you will enjoy this book.

