Gifts of Intellectual Property

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The democratization of technology means that more people are able to create and transfer intellectual property, including patents, trademarks and copyrights, while increased demand for these assets has increased their value dramatically. Charitable contributions of these intangible assets are subject to a surprisingly complex matrix of tax rules governing the tax benefits arising from those contributions.

Intellectual property can include trade secrets, royalty interests and other intangible property, but the most common categories are:

- **Copyrights.** A copyright is an exclusive right to make copies, license, or otherwise exploit a literary, musical, or artistic work, whether printed, audio, video, or in other media. Registration of the work is not required, but helps establish the rights of a copyright owner in the event of a challenge. The rights of the author are protected for his or her life plus fifty years.

- **Patents.** Patents are issued by the US Patent and Trademark Office. While also issued to protect designs and certain types of plants, the most common variety consists of utility patents, issued for invention of new processes, machines, manufactures, or compositions of matter. These patents are issued for a term of up to twenty years. Patents and assignments must be recorded with the USPTO to be enforceable.

- **Trademarks.** A trademark can be a symbol, words or a design representing a product or company. Registration with the USPTO is not required, but creates a presumption of ownership and the exclusive right to use the mark in connection with the goods or services that are listed in the trademark registration. Unlike copyrights and patents, trademark rights can last indefinitely, so long as the owner continues to use the mark to identify its goods or services. Periodic filings with the USPTO are required.

1. Charitable Contribution Deduction – In General. The charitable deduction that would otherwise be allowed by Code section 170 for a charitable contribution of intellectual property (other than a copyright described in section 1221(a)(3) – see below) is reduced by section 170(e)(1)(B)(iii) by the amount of gain that would have been long-term capital gain if the property had been sold by the donor. (See attached references.)

2. Special Rule for Copyrights Created by the Donor. Code section 1221(a)(3) excludes from the definition of a capital asset a copyright held by the person whose personal efforts created it. For example, the copyright to a novel is not a capital asset in the hands of the author. Also excluded under this provision is a letter, memorandum, or similar property, prepared *for* the donor.

a. The charitable contribution of a copyright by the author is reduced to his or her basis in the copyright under the normal rules of section 170(e)(1)(A) which provides that the deduction

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is reduced by the amount of gain that would *not* have been long-term capital gain if sold by the donor, i.e. in this case ordinary income from the sale of an asset that is not a capital asset.

3. Additional Deduction for Qualified Donee Income. A donor who makes a qualified intellectual property contribution may claim an additional deduction for a percentage of qualified donee income derived by the charity from its exploitation of the property subsequent to the contribution.

a. Qualified intellectual property is property described in section 170(e)(1)(B)(iii) contributed to a public charity, provided that the original deduction was reduced under that subsection (other than property contributed to a private foundation).

b. Qualified donee income (QDI) is any net income received or accrued by the donee charity which is allocable to the donated property.

c. The donor is entitled to claim an additional deduction based on a percentage of QDI derived by the donee, declining from 100% in year 1 to 10% in year 12 following the contribution (limited to the useful life of the intellectual property).

d. The donor must inform the charity at the time of the gift that she intends to treat the gift as a qualified intellectual property contribution.

e. Once so notified, section 6050L requires the charity to file a return each year detailing the QDI and to provide the donor with a copy of the return (Form 8899).

4. The Sequence of Inquiry.

a. Is the donated property a copyright?

b. If so, was it created by or for the donor? The deduction is limited to the lesser of the basis or FMV of the copyright.

c. For all other intellectual property, deduction is the lesser of the basis or FMV of the property *plus* percentage of QDI.

5. Example 1. Doctor invented a medical device and obtained a patent. Her cost basis, consisting of the capitalized costs, including materials, of developing the device, is $100,000. When manufacturers become interested in the device, she assigns the patent to her *alma mater* and informs the university that she intends to treat the gift as a qualified intellectual property contribution. The next year, the university licenses the patent to a manufacturer for an advance against royalties of $1 million.

a. The university files Form 8899 reporting the $1 million payment in year 2 and provides a copy to Doctor.

b. Doctor may claim a deduction in year 1 for her cost basis of $100,000, assuming she obtains a qualified appraisal of the patent for at least that amount. The deduction may offset up to 50% of her AGI because the 30% limitation of section 170(b)(1)(C) does not apply. (The 30% limitation applies to "capital gain property to which subsection (e)(1)(B) does not apply.")

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c. Doctor may claim a deduction in year 2 of $1 million in year 2, since in that year she may claim 100% of QDI, *less* the amount of her deduction in year 1, or $900,000. The 50% AGI appears to apply to this deduction as well: because the contribution was subject to section 170(e)(1)(B), the 30% limit does not apply. Note that these rules might put the Doctor in a much better position than if section 170(e)(1)(B)(iii) had not been added to the Code in 2004.

6. Example 2. Rocker owns the trademark for his band consisting of a distinctive design. He has registered the mark for the sale of tee shirts and other products sold at the band's concerts. He contributes the merchandise trademark to a national disaster relief charity. He has no basis in the trademark, since he got his roommate to do the artwork for free, but he has the forethought to inform the charity that he intends to treat the gift as a qualified intellectual property contribution. It takes the band a few years, but they are eventually signed by a promoter who sends them on a tour starting in year 5 after the assignment of the trademark to the charity, and licenses the trademark for sale of merchandise at every venue. The charity earns $100,000 in year 5, $200,000 in year 6, and $300,000 in year 7, after which the band breaks up and they can't sell any more tee shirts. Rocker's deduction:

Year 5	70% of $100,000	$70,000
Year 6	60% of $200,000	$120,000
Year 7	50% of $300,000	$150,000
	Total	$340,000

Note that if Rocker had waited to assign the merchandise trademark until the band was actually ready to start touring, he could claim the deductions in the same years, but they would be much higher:

Year 1	100% of $100,000	$100,000
Year 2	100% of $200,000	$200,000
Year 3	90% of $300,000	$270,000
	Total	$470,000

7. Example 3. Author has written several best-selling novels. He already received a large advance from a publisher for rights to his most recent book, which is now selling nicely. His agent encourages Author to offer the rights to a graphic novel version of the book, which the agent thinks could command an advance of $ 1 million. Author is interested, but doesn't need the money right now, since his books are selling well. He is more concerned about the future, when his writing may no longer be in fashion.

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a. He assigns the graphic novel rights to a NIMCRUT providing income to Author and his wife for life, with the maximum unitrust percentage that results in a 10% present value of the charitable remainder, which he reserves the right to name later.

b. The agent comes through, and licenses the graphic novel rights, on behalf of the CRT, which receives an advance of $1 million.

c. Author has no cost basis in the graphic novel rights, so there is no charitable deduction since he is the creator of this copyright. On the other hand, the trust has $1 million to invest for the future benefit of Author and his wife, as income beneficiaries, and for the charitable remainder beneficiary, rather than the $500,000 that Author would have had after tax in his 50% effective state and federal tax bracket.

d. A year later, Author has another best-seller on his hands and his planning objectives have changed. Rather than preserve an income stream for the future, which he now feels is secure, he would like to fund a major charitable commitment to his *alma mater* to fund its creative writing program, so he and his wife assign their income interest in the NIMCRUT to the College, name the College as successor trustee, and irrevocably designate the College as remainder beneficiary. Obtaining a qualified appraisal and contemporaneous written acknowledgement, Author claims a charitable income tax deduction of $900,000, subject to the 30% AGI limitation since the income interest is a capital asset with a zero basis under section 1001(e), which isn't a problem in view of the $3 Million advance he just got for a five-book deal. Note that this sequence puts the novelist in a much better position than if he had contributed the graphic novel rights directly to the College.

8. A Problem with Copyrights. Federal law gives an author the right to terminate an assignment of copyright 35 years after its assignment or initial publication, whichever is earlier. Can a copyright owner make a completed gift eligible for an income tax deduction if the author has the right to reclaim the copyright? This may not be a problem if the donor is the author since he or she would only be entitled to a deduction equal to basis. But what if the donor is not the author? Perhaps she acquired a portfolio of copyrighted software. She paid a lot, but doesn't worry about the author's termination right because the useful life of the software is much shorter than 35 years. But if she transfers one of the copyrights to charity, which turns around and licenses it for $1 Million, will the donor be entitled to claim a deduction for QDI under section 170(m)?

a. Termination rights do not apply to copyrights treated as works for hire under federal law, so if the copyrights were created by a software developer that employed an army of coders, this issue does not arise.

9. Another Problem with Copyrights. The general rule of section 170(f)(3) denies a charitable deduction for a gift of a partial interest in property. But modern intellectual property is frequently cut into many pieces with the pieces exploited separately. Even if the property is not a copyright, or if it is and the donor is not the creator, does the partial interest rule bar a deduction?

a. The pieces may be derivative works that qualify as separate copyrights. For example, the graphic novel rights from Example 3 is eligible for copyright protection as a derivative work

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for the added elements, like the artwork, but not the underlying story or characters, so the partial interest rules should not deny a deduction for a contribution of this asset.

b. This problem does not arise with the tee shirt trademark in Example 2, since the trademark for the band is in a separate category from the trademark for the tee shirts, making it clear that they are separate property rights.

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References

Internal Revenue Code

§ 170 Charitable, etc., contributions and gifts.

…

(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 under this section shall be reduced by the sum of-

(A) the amount of gain which would not have been long-term capital gain (determined without regard to section 1221(b)(3)) if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution), and

(B) in the case of a charitable contribution-

…

(iii) of any patent, copyright (other than a copyright described in section 1221(a)(3) or 1231(b)(1)(C)), trademark, trade name, trade secret, know-how, software (other than software described in section 197(e)(3)(A)(i)), or similar property, or applications or registrations of such property, or

…

the amount of gain which would 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).

…

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(m) Certain donee income from intellectual property treated as an additional charitable contribution.

(1) Treatment as additional contribution.

In the case of a taxpayer who makes a qualified intellectual property contribution, the deduction allowed under subsection (a) for each taxable year of the taxpayer ending on or after the date of such contribution shall be increased (subject to the limitations under subsection (b)) by the applicable percentage of qualified donee income with respect to such contribution which is properly allocable to such year under this subsection .

(2) Reduction in additional deductions to extent of initial deduction.

With respect to any qualified intellectual property contribution, the deduction allowed under subsection (a) shall be increased under paragraph (1) only to the extent that the aggregate amount of such increases with respect to such contribution exceed the amount allowed as a deduction under subsection (a) with respect to such contribution determined without regard to this subsection .

(3) Qualified donee income.

For purposes of this subsection, the term "qualified donee income" means any net income received by or accrued to the donee which is properly allocable to the qualified intellectual property.

(4) Allocation of qualified donee income to taxable years of donor.

For purposes of this subsection, qualified donee income shall be treated as properly allocable to a taxable year of the donor if such income is received by or accrued to the donee for the taxable year of the donee which ends within or with such taxable year of the donor.

(5) 10-year limitation.

Income shall not be treated as properly allocable to qualified intellectual property for purposes of this subsection if such income is received by or accrued to the donee after the 10-year period beginning on the date of the contribution of such property.

(6) Benefit limited to life of intellectual property.

Income shall not be treated as properly allocable to qualified intellectual property for purposes of this subsection if such income

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is received by or accrued to the donee after the expiration of the legal life of such property.

(7) Applicable percentage.

For purposes of this subsection, the term "applicable percentage" means the percentage determined under the following table which corresponds to a taxable year of the donor ending on or after the date of the qualified intellectual property contribution:

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

(8) Qualified intellectual property contribution.

For purposes of this subsection, the term "qualified intellectual property contribution" means any charitable contribution of qualified intellectual property-

(A) the amount of which taken into account under this section is reduced by reason of subsection (e)(1) , and

(B) with respect to which the donor informs the donee at the time of such contribution that the donor intends to treat such contribution as a qualified intellectual property contribution for purposes of this subsection and section 6050L .

(9) Qualified intellectual property.

For purposes of this subsection , the term "qualified intellectual property" means property described in subsection (e)(1)(B)(iii)

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(other than property contributed to or for the use of an organization described in subsection (e)(1)(B)(ii)).

(10) Other special rules.

(A) Application of limitations on charitable contributions. Any increase under this subsection of the deduction provided under subsection (a) shall be treated for purposes of subsection (b) as a deduction which is attributable to a charitable contribution to the donee to which such increase relates.

(B) Net income determined by donee. The net income taken into account under paragraph (3) shall not exceed the amount of such income reported under section 6050L(b)(1) .

(C) Deduction limited to 12 taxable years. Except as may be provided undersubparagraph (D)(i) , this subsection shall not apply with respect to any qualified intellectual property contribution for any taxable year of the donor after the 12th taxable year of the donor which ends on or after the date of such contribution.

(D) Regulations. The Secretary may issue regulations or other guidance to carry out the purposes of this subsection , including regulations or guidance-

(i) modifying the application of this subsection in the case of a donor or donee with a short taxable year, and

(ii) providing for the determination of an amount to be treated as net income of the donee which is properly allocable to qualified intellectual property in the case of a donee who uses such property to further a purpose or function constituting the basis of the donee's exemption under section 501 (or, in the case of a governmental unit, any purpose described in section 170(c)) and does not possess a right to receive any payment from a third party with respect to such property.

§ 1221 Capital asset defined.

(a) In general.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include-

…

(3) 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,

(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) ;

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Federal Regulations

Reg § 1 . 1221 - 1 . Meaning of terms.

(a) The term "capital assets" includes all classes of property not specifically excluded by section 1221. In determining whether property is a "capital asset", the period for which held is immaterial.

…

(c)

(1) A copyright, a literary, musical, or artistic composition, and similar property are excluded from the term "capital assets" if held by a taxpayer whose personal efforts created such property, or if 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 in part by reference to the basis of such property in the hands of a taxpayer whose personal efforts created such property. For purposes of this subparagraph, 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.

(2) In the case of sales and other dispositions occurring after July 25, 1969, a letter, a memorandum, or similar property is excluded from the term "capital asset" if held by (i) a taxpayer whose personal efforts created such property, (ii) a taxpayer for whom such property was prepared or produced, or (iii) 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 in part by reference to the basis of such property in the hands of a taxpayer described in subdivision (i) or (ii) of this subparagraph. In the case of a collection of letters, memorandums, or similar property held by a person who is a taxpayer described in subdivision (i), (ii), or (iii) of this subparagraph as to some of such letters, memorandums, or similar property but not as to others, this subparagraph shall apply only to those letters, memorandums, or similar property as to which such person is a taxpayer described in such subdivision. For purposes of this subparagraph, the phrase "similar property" includes, for example, such property as a draft of a speech, a manuscript, a research paper, an oral recording of any type, a transcript of an oral recording, a transcript of an oral interview or of dictation, a personal or business diary, a log or journal, a corporate archive, including a corporate charter, office correspondence, a financial record, a drawing, a photograph, or a dispatch. A letter, memorandum, or property similar to a letter or memorandum, addressed to a taxpayer shall be considered as prepared or produced for him. This subparagraph does not apply to property, such as a corporate archive, office correspondence, or a financial record, sold or disposed of as part of a going business if such property has no significant value separate and apart from its relation to and use in such business; it also does not apply to any property to which subparagraph (1) of this paragraph applies (i.e., property to which section 1221(3) applied before its amendment by section 514(a) of the Tax Reform Act of 1969 (83 Stat. 643)).

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(3) For purposes of this paragraph, in general, property is created in whole or in part by the personal efforts of a taxpayer if such taxpayer performs literary, theatrical, musical, artistic, or other creative or productive work which affirmatively contributes to the creation of the property, or if such taxpayer directs and guides others in the performance of such work. A taxpayer, such as corporate executive, who merely has administrative control of writers, actors, artists, or personnel and who does not substantially engage in the direction and guidance of such persons in the performance of their work, does not create property by his personal efforts. However, for purposes of subparagraph (2) of this paragraph, a letter or memorandum, or property similar to a letter or memorandum, which is prepared by personnel who are under the administrative control of a taxpayer, such as a corporate executive, shall be deemed to have been prepared or produced for him whether or not such letter, memorandum, or similar property is reviewed by him.

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