Equity and Efficiency in Intellectual Property Taxation

Abstract: The article critiques the federal income tax regime governing intellectual property using normative criteria in evaluating taxes: equity and efficiency. Identifying numerous inequities and inefficiencies in the tax system’s treatment of intellectual property, the article argues that a rational and coherent legal framework is necessary for intellectual property tax rules. The article suggests that an appropriate framework should consider the extent to which the tax system should be in harmony with the intellectual property system, establish the basis for rational tax distinctions, if distinctions are to be adopted, and reconcile tax treatments of intangible and tangible capital.

I. INTRODUCTION

Intellectual property assets are integral to U.S. business. Companies, large and small, spend a great amount of resources to create and develop products and services that are covered by patents, copyrights, trade secrets, and trademarks. If they lack the expertise, the facilities, financing, and time, they license the various intellectual property rights from others to operate their businesses; segmentation is the business modes operandi. Multinational companies shuffle and migrate their intellectual property assets to favorable state and foreign jurisdictions for tax, employment, and productivity reasons. Some companies leverage their intellectual property assets for financing, while others leverage for litigation purposes. As intellectual property assets are highly valuable, companies seek different forms of intellectual property that are available to protect their particular products or services, bundling multiple intellectual property rights.

The importance of intellectual property to the U.S. economy underscores the need for a sound U.S. tax policy governing intellectual property rights. The federal tax system can be designed to either support or hinder intellectual property goals. Presently, the Internal Revenue Code (“Code”) contains several special rules governing intellectual property. Some of the special tax provisions affect a large group of intellectual property assets. Most, however, are mutually exclusive, and affect only specific types of intellectual property. Many of these special tax rules governing intellectual property were designed to address early problems encountered when intellectual property transactions were analyzed under the traditional principles of taxation. But many of the special tax rules are circumscribed in ways that relegate the tax analysis back under general tax principles. Thus, the current income tax system governing intellectual property is a mixture of special rules and traditional principles of taxation.

This article evaluates the current U.S. income tax regime governing intellectual property focusing on two traditional criteria used in evaluating tax systems: tax fairness and efficiency.

Part II of this article explores whether the current tax scheme governing intellectual property is fair. The tax application of fairness is usually described in terms of the principles of horizontal and vertical equity. Horizontal equity requires that persons who are similarly situated should be taxed in a similar fashion; vertical equity dictates that persons whose situations are different should be taxed differently. A related concept of equity is that economically equivalent activities should be taxed in the same manner even though they may differ in form.

Some modern tax theorists have challenged the virtue of horizontal equity in tax policy analysis, contending that horizontal equity lacks independent significance and is devoid of any normative content.
Critics who question the utility of horizontal equity in evaluating tax rules often point to the difficulty in determining relevant likeness (i.e., proper comparisons of taxpayers and economic activities). This would seem particularly apropos with respect to intangible intellectual property rights. For example, should a person selling a literary copyright and a person selling a musical copyright be treated as equals for tax purposes? Should a purchaser of a domain name functioning as a trademark be considered equal to a purchaser of a generic domain name? Critics of horizontal equity argue that requiring equal treatment for equals merely begs the question of what are equals. But this criticism rests on an “exaggerated view of the level of precision required in order for equality to have meaning.” As noted by one commentator, “horizontal equity is concerned with individuals who are ‘similarly situated,’ not with those who are ‘identically situated.’” Even if the criticism is accepted, horizontal equity could nevertheless be viewed as a useful tool to uncover potential problems in a tax system. For example, the fact that two intellectual property owners who appear to be in similar economic circumstances are treated differently for tax purposes might signal that the intellectual property tax system contains a flaw or at least challenge us to justify disparate treatment. Horizontal equity was once regarded as the primary goal of tax policy, and recent defenders of horizontal equity have proffered valid arguments that equity remains an important principle of tax theory that cannot be dismissed. To that end Part II of this article uses horizontal equity in evaluating the current tax scheme governing intellectual property, identifying differences in tax treatment of what appear to be similar intellectual property transactions. Part II highlights the need for a normative framework for intellectual property taxation that establishes a basis for rational tax distinctions among intellectual property if distinctions are to be maintained.

Part III of the article attempts to identify inefficiencies in the current intellectual property tax scheme. This is not an easy tax, as efficiency, in tax theory, has been measured by contradictory standards and means various things in various contexts. Efficiency can be viewed as a utilitarian concept requiring that we should seek a balance between maximizing tax revenues and minimizing the social costs of taxation. Under this efficiency standard, an optimal intellectual property tax system would be neutral (i.e., it would not interfere with intellectual property owners’ economic behavior and would avoid deadweight losses caused by taxpayers’ restructuring of intellectual property transactions to minimize taxes. But the usefulness of this standard in evaluating the intellectual property tax system is questionable since most tax rules governing intellectual property are deliberately non-neutral and would be viewed as having high efficiency costs. Many of the special tax provisions governing patents and copyrights, for example, were a deliberate attempt to support the social utility mandate of the patent and copyright laws. At least with respect to the intellectual property tax scheme, neutrality violations are inevitable to achieve more important intellectual property social engineering policies and advance the public interest.

An appropriate measure of efficiency in intellectual property taxation might focus on gains to society. Indeed, some commentators describe efficiency in terms of economic growth. Under this standard, the intellectual property tax system would be viewed as efficient if it promoted economic growth; the tax system would be inefficient if it inhibited such growth. Under this meaning of efficiency, tax subsidies (i.e., tax expenditures in the form of deductions and credits) for certain intellectual property activities might upset the free market allocations of capital, but might be justified because the targeted activities involve significant beneficial externalities. And if these subsidies correctly quantified society’s interests, they would be seen as contributing to market efficiency. Thus, Part III of this article evaluates numerous tax subsidies for intellectual property to assess whether they adequately promote economic growth. It is argued that too often tax expenditures for intellectual property are circumscribed in ways that limit their effectiveness, and, hence, do not optimally contribute to efficiency in the market.

The design of any tax system involves tradeoffs between equity and efficiency principles. For example, it may be efficient to provide tax breaks to certain innovators because society as a whole benefits from high innovation via encouragement of individual effort by personal gain. But such
measures may violate horizontal equity. Because conflicts between equity and efficiency are often inevitable, a legal framework for intellectual property tax rules should establish reasonable tradeoffs. A framework, for example, might decide whether to grant equity primacy over efficiency or vice versa. If inequity gives way to efficiency, the framework might decide on an acceptable level of aversion to inequality (e.g., horizontal equity violations might be justified only if efficiency gains are significant).

Part II of this paper exposes numerous inequities in the tax system’s treatment of intellectual property and Part III identifies inefficiencies in the intellectual property taxation scheme, which serve to hinder, as opposed to promote, beneficial intellectual property activity. These sections highlight the defective nature of the current tax scheme and the need for a set of rational and coherent tax rules applicable to intellectual property.

Part IV suggests that an appropriate legal framework is needed for federal tax legislation governing intellectual property, and proffers components for a possible new framework. First, a framework should consider the extent to which harmonization should be achieved between intellectual property and taxation schemes (the efficiency criterion). While the current system aims to promote the innovation goals of patents and patent-like property, it arguably hinders beneficial copyright and trademark goals. Second, a framework should establish a basis for rational tax distinctions for intellectual property if these distinctions are to be maintained (the equity criterion). The current tax system, which contains different rules for different types of intellectual property, is inflexible and not easily applied to future innovations and intellectual property movements, such as the bundling of intellectual property rights in business practice today. Finally, a framework should reconcile the tax treatments of intangible and tangible capital, since the current tax treatments are irrational.