COMMENTS ON "TAXATION OF INTELLECTUAL CAPITAL:" BETTER THAN CONSUMPTION-TAX TREATMENT?

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In *Taxation of Intellectual Capital*, Professor Lily Kahng[1] argues that U.S. tax law is fundamentally flawed because it allows businesses to "expense" investments in self-created intangibles.[2] The article draws on research in related areas (knowledge management, financial accounting, and national accounting) that seeks to identify and measure "intellectual capital," "a central driver of economic productivity and growth."[3] Within the framework of a normative income tax, Professor Kahng argues that businesses should be required to capitalize and amortize investments in a broad array of intangibles, including research and development, advertising, and employee-training expenses.

I. FUNDAMENTAL FLAW

The problem of self-created business intangibles is peculiar to a normative income tax. From an income tax perspective, the immediate deduction of self-created business intangibles may be viewed as an implicit subsidy equivalent to exempting the return from such investments from tax.[4] By contrast, under a consumption (or cash-flow) tax, expensing of business expenses (salaries and business investments) promotes neutrality in the taxation of capital income.[5]

Professor Kahng's article comes down squarely in favor of normative income tax principles.[6] Basically, she recommends codifying a modified version of the "future benefits" test articulated by the Supreme Court in *INDOPCO, Inc. v. Commissioner*.[7] The pre-

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1. 66 FLA. L. REV. 2229 (2014).

2. *See id.* at 2232–33.

3. *Id*. at 2229; *see id*. at 2257 (generally using "intangibles" interchangeably with "intellectual capital"). *See also* George Mundstock, *Taxation of Business Intangible Capital*, 135 U. PA. L. REV. 1179, 1185–86 (1987) (defining "intangible capital" and "intangible capital expenditures").

4. *See* Kahng, *supra* note 1, at 2263; *see also* Calvin H. Johnson, *First Do No Harm: The Senate Staff Discussion Draft on Cost Recovery*, TAX NOTES, Feb. 3, 2014, at 551.

5. *See generally* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1167–68 (1974).

6. *See* Kahng, *supra* note 1, at 2266 ("[F]oundational principles of tax law and Supreme Court jurisprudence . . . dictate that taxpayers must capitalize investments in intellectual capital.").

7. INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 87–88 (1992). The expenses in *INDOPCO* were clearly nondeductible, since they fit within the well-established category of "corporate restructurings." *Id*. at 89–90. Thus, the Court's language concerning the relevance of a "future benefit" was dictum.

INDOPCO case law may be viewed as merely requiring capitalization of intangibles that were asset-related or otherwise easily identified as "separate" assets.[8] Since virtually any business expenditure may be viewed as producing some future benefit, an expansive reading of *INDOPCO* threatened to upset settled law. Not surprisingly, legions of lobbyists (and some prominent tax lawyers) urged the Treasury to adopt a narrow reading of *INDOPCO*, arguing that the incidental future benefits test was essentially incoherent because it failed to draw a clear line between ordinary (currently deductible) and capital expenditures.[9]

Following *INDOPCO*, the Treasury faced the dilemma (with no assistance from Congress) of balancing the administrative costs of policing an ambiguous capitalization standard against the putative benefits of stricter capitalization requirements. The so-called anti-*INDOPCO* regulations basically reinstate the asset-related requirement of prior law.[10] The resulting regulatory compromise is easy to criticize. Why, for example, should a business be allowed to deduct the entire salary expense of in-house employees if, in connection with a corporate acquisition or expansion, the cost of such services would be capitalized and amortized when performed by a third party?[11] Nevertheless, such line-drawing permeates every corner of tax law, and the administrative difficulties posed by a broad reading of *INDOPCO* should not be underestimated.[12]

II. CREATED VERSUS PURCHASED INTANGIBLES

Under Professor Kahng's proposal, self-created business intangibles with a significant future benefit would generally be capitalized and amortized over five years.[13] Admittedly, a uniform five-year recovery

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8. Justice Blackmun's earlier opinion in another case helped to cement the "separate asset" test. *See* Comm'r v. Lincoln Savs. & Loan Ass'n., 403 U.S. 345, 354 (1971).

9. *See* Joseph Bankman, *The Story of INDOPCO: What Went Wrong in the Capitalization v. Deduction Debate?*, in TAX STORIES 225, 238–39, 246–47 (Paul L. Caron ed., 2009).

10. *See* 26 C.F.R. § 1.263(a)–4 (2014). Expenses related to intangibles are presumptively deductible, subject to a narrow exception requiring capitalization of expenses that "facilitate" a business restructuring, consistent with *INDOPCO* and prior law. 26 C.F.R. § 1.263A–5 (2014). *See* Kahng, *supra* note 1, at 2257 (referring to "deductibility as the default rule").

11. *See* 26 C.F.R. § 1.263(a)–4(c)(3) (2014). Outside the area of self-created intangibles, the main issue is whether expenses are "repairs" (deductible) or "improvements" (capitalized). *See* 26 C.F.R. § 1.263(a)–3 (2014).

12. *See* Jane G. Gravelle & Jack Taylor, *Tax Neutrality and the Tax Treatment of Purchased Intangibles*, 45 NAT. TAX J. 77, 79 (citing "administrative simplicity" as a principal concern); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1627–28 (1999). *Cf.* Kahng, *supra* note 1, at 2270–71 ("[A]dministrative concerns about the uncertainty and difficulty of valuation do not justify a default rule of deductibility.").

13. *Id.* at 2274–76.

period for the diverse types of self-created business intangibles is arbitrary. Nevertheless, the administrative convenience of grouping all such assets within a single class for amortization purposes might offset any resulting inaccuracy.[14] In the case of *purchased* business intangibles (including the residual categories of goodwill and going concern value), section 197 allows a 15-year recovery period for any covered intangibles. Section 197, hastily enacted in the wake of the government's defeat in *Newark Morning Ledger Co. v. United States*,[15] strikes a compromise to preserve revenue neutrality, creating both "winners" and "losers."[16] If a corporate seller can expense expenditures (such as advertising) that produce goodwill and a corporate buyer receives an immediate deduction for purchased goodwill, the overall result may be no *net* tax to anyone.[17] Even if the seller's gain is capital and the buyer's deductions are ordinary, the absence of a *corporate* capital gain preference tends to limit potential tax arbitrage.[18]

If a noncorporate business with goodwill is sold, however, capital gain treatment may matter greatly to the individual sellers. Consider, for example, three individuals who form an investment firm (taxed as a partnership) and establish three investment funds that they manage for several years. The founders receive a mix of ordinary income for their management services and a right to a share of the appreciation in the underlying assets of the investment funds (a "carried interest").[19] On

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14. Given the dramatic undertaxation of self-created intangibles, even capitalization coupled with noneconomic amortization might be neutrality-enhancing. *See* Ethan Yale, *When Are Capitalization Exceptions Justified?*, 57 TAX L. REV. 549, 565–66 (2004); *id*. at 574 (noting "high tolerance for error").

15. Newark Morning Ledger Co. v. United States, 507 U.S. 546, 551 (1993) (allowing taxpayer to amortize customer-based intangibles based on their estimated useful life). The government argued that customer-based intangibles were inseparable from goodwill and hence could not be amortized.

16. *See generally* GEORGE K. YIN & KAREN C. BURKE, CORPORATE TAXATION 355 (2011) (The Court's pro-taxpayer decision allowed section 197 to be scored as budget neutral). By leaving unchanged the 15-year amortization period under section 197, Professor Kahng's proposal would reduce but not eliminate the disparate tax treatment of created and purchased intangibles.

17. Since the expensed goodwill has a zero tax basis in the seller's hands, the seller is taxed on capital gain equal to the fair market value of the sold goodwill; the seller's tax detriment (assuming identical rates) is exactly offset, however, by the buyer's tax benefit from immediately deducting the purchased goodwill. Thus, the buyer and seller will presumably adjust the purchase price to reflect the no-tax result.

18. *See* 26 U.S.C. § 1202 (2014). If, as under current law, the purchased goodwill cannot be deducted immediately, the seller's tax detriment will generally outweigh the buyer's tax benefit.

19. The tax consequences of the fees earned by private-equity managers (who typically receive an annual management fee equal to 2% of the fund and 20% of the fund profits) have sparked considerable controversy. *See generally* George K. Yin & Karen C. Burke, PARTNERSHIP TAXATION 305–07 (2d ed. 2013) (describing the principal advantage of the current

sale of their partnership interests, the founders recognize a large gain attributable to "enterprise value" (i.e., the value in excess of the current value of the underlying investment assets of the different funds).[20] Because this enterprise value—attributable largely to the founders' "sweat equity"—represents a future expectancy in the nature of goodwill, the founders claim that the excess value should be taxed entirely as capital gain.[21]

The sale of a service partnership's "goodwill" obviously raises the issue of whether some portion of the founders' gain should be taxed as ordinary (rather than capital) gain because of the service "taint."[22] Perhaps less obvious is the issue of whether income should be imputed to sole proprietors and partners for the value of their services.[23] The (taxable) imputed income would be deemed to be "reinvested" in the business, generating a self-created intangible that (under Professor Kahng's proposal) could be written off over a five-year period.[24] Of course, concerns about speculative valuation might give rise to a wait-and-see approach.[25] Indeed, such valuation concerns—coupled with the limits of transaction-based and expectation-based accounting under an income tax system—help to explain the persistence of the flawed tax treatment of intangibles.[26]

III. BROADER PICTURE

The treatment of self-created intangibles is likely to play a central role in the current debate over reform of business taxation.[27] Replacing expensing of scientific research and development (R&D) expenditures with capitalization and five-year amortization is estimated to raise

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tax treatment as exploiting the tax differences between managers and fund investors); *see also* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008).

20. *See* Jack S. Levin et al., *Carried Interest Legislative Proposals and Enterprise Value Tax*, TAX NOTES, Nov. 1, 2010, p.1.

21. *See id.* at 12–14 (analogizing enterprise value to founders' equity in start-up corporations).

22. If the buyer obtains ordinary deductions for purchased goodwill, taxing the seller's gain as ordinary at least stymies a blatant opportunity for tax-rate arbitrage.

23. *See* Mundstock, *supra* note 3, at 1248.

24. Ignoring timing issues, the imputed income and amortization deductions would offset each other, but managers would be required to pay employment taxes on their imputed income from services.

25. *See generally* YIN & BURKE, CORPORATE TAXATION, *supra* note 16, at 307 (noting that a "back-end" approach would alleviate some valuation problems of taxing receipt of a valuable profits interest at the front end).

26. *See* Mundstock, *supra* note 3, at 1239.

27. *See* Johnson, *supra* note 4, at 549 (discussing various congressional proposals).

$192.6 billion over ten years.[28] The increased annual revenue of roughly $20 billion could be used to finance a reduction in the U.S. corporate tax rate by two percentage points.[29] Despite the apparent political consensus on the desirability of a lower corporate tax rate to improve the international "competitiveness" of U.S. businesses,[30] Congress is unlikely to eliminate the implicit subsidy for R&D as a tradeoff for a lower corporate tax. Opponents would surely decry such base broadening as "undercut[ting] tax incentives for knowledge creation and technological innovation" and driving high-paying jobs offshore.[31]

Since 1981 the U.S. has had a "temporary" (but repeatedly extended) R&D tax credit that seeks to encourage incremental R&D investment (over a base amount) with valuable "spillover" benefits, on the theory that such investment otherwise might not occur.[32] With expensing, a 5% tax credit reduces the tax rate on an investment that produces a 10% return to negative 29.2% and allows the investment to "shelter" unrelated income.[33] R&D expenditures also enjoy an "accidental" tax benefit attributable to tax planning that permits U.S. corporations to shift profits to tax havens (while deducting associated expenses at higher U.S. rates).[34] Taken together, these subsidies suggest that R&D investments may receive even more favorable treatment (for taxpayers) under current law than under a consumption tax.

CONCLUSION

Whether one favors income or consumption taxation, Professor Kahng is right to be concerned about the tax treatment of intangibles. Such outlays represent a significant and increasing component of the U.S. economy, highlighting the tradeoff between the tax policy goals of simplicity and neutrality. As Professor Kahng's article demonstrates, the seemingly arcane issue of properly accounting for intangibles is too

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28. *See* Kahng, *supra* note 1, at 2276–77 (extrapolating that the proposal might raise as much as $1 trillion of revenue over ten years, assuming R&D accounts for one-fifth of all investments in business intangibles).

29. *See* Martin A. Sullivan, CORPORATE TAX REFORM: TAXING PROFITS IN THE 21ST CENTURY 5 (2011) (estimating that a 10 percentage-point decrease in corporate tax rate would lose approximately $100 billion of revenue annually).

30. *See, e.g.*, Jordan M. Barry, *The Emerging Consensus for Cutting the Corporate Income Tax Rate*, 18 CHAPMAN L. REV. 19, 19–20 (2014).

31. Martin A. Sullivan, *Will International Tax Reform Slow U.S. Technology Development?*, TAX NOTES, Nov. 4, 2013, at 461 [hereinafter Sullivan, *International Tax*].

32. *See* 26 U.S.C. § 41 (2014).

33. *See* Sullivan, *International Tax*, *supra* note 31, at 460.

34. *See id.* at 460. Other countries have enacted so-called "patent boxes" that provide a low rate of tax on certain intangibles income. *See generally* Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347 (2013) (finding little evidence to support the efficacy of patent boxes).

important to be left solely to accountants.