ILLUMINATING THE DARK MATTER OF INTELLECTUAL CAPITAL

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In a properly functioning income tax, business and investment deductions would be permitted only for costs that represent true decreases in wealth.[1] Events that merely transform one form of wealth into another of equal value should not give rise to a current deduction under a normative income tax.[2] Discussions about the appropriate test for capitalization are therefore, at their core, discussions about how to distinguish continuations in wealth from deductible business or investment decreases in wealth. That the capitalization norm is implemented incorrectly in multiple instances is readily apparent at a basic level. For example, it is commonplace for students to express concerns about the near total deductibility of advertising costs given the Supreme Court's position that capitalization should be required for outlays generating future benefits.[3]

The distance between the capitalization norm and its implementation is not limited to advertising. Indeed, current tax rules allow deductions for virtually all amounts a business spends on developing and promoting its own identity and expertise. The deductibility for costs relating to self-created intellectual capital problematically suggests that the tax system does not regard this capital as a form of wealth. Professor Lily Kahng's article, *The Taxation of Intellectual Capital*, highlights the distortion contained in the current tax rules governing capitalization.[4] Her article emphasizes that U.S tax law systematically fails to require capitalization for self-created, high-value intangible assets. Professor Kahng's contribution is to situate the problem in a broader, interdisciplinary context

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1. For a discussion of the normative income tax, *see* Charlene Luke, *What Would Henry Simons Do?: Using an Ideal to Shape and Explain the Economic Substance Doctrine*, 11 HOUS. BUS. & TAX L.J. 108, 127–36 (2011). The title of this review, *Illuminating the Dark Matter of Intellectual Capital*, is drawn from an analogy used by Professor Lily Kahng in the article under discussion. Lily Kahng, *The Taxation of Intellectual Capital*, 66 FLA. LAW REV. 2229, 2231 (2014) ("intellectual capital has also been likened to dark matter—the essential substance that binds the universe but is not directly observable"); *id.* at 2234 ("In keeping with its comparison to 'dark matter,' scholars sometimes define [intellectual capital] by what it is not").

2. While the theoretical contours of a normative income tax are relatively uncontroversial, implementation creates sharp disagreement regarding the various definitional elements, including debate about what criteria should establish "wealth," "cost," "business," or "investment." *See* Luke, *supra* note 1, at 136–46.

3. *See* INDOPCO, Inc. v. Comm'r., 503 U.S. 79, 87 (1992) ("Although the mere presence of an incidental future benefit . . . may not warrant capitalization, a taxpayer's realization of [future benefits] is undeniably important . . . ."). Even Treasury regulations promulgated under the strong capitalization requirements of Internal Revenue Code section 263A permit advertising to escape capitalization. 26 C.F.R. § 1.263A-1(e)(4)(iv)(N).

4. *See generally* Kahng, *supra* note 1.

and to use the knowledge gained from that context to suggest specific reforms.[5] In the process, Professor Kahng explores the definitional boundaries of "intellectual capital" and considers potential objections to capitalization of the costs of intellectual capital. As a result, Professor Kahng's article fosters a richer, contextualized conversation about a significant shortcoming of the tax system.

Professor Kahng draws on three interdisciplinary sources of evidence. Each source represents the interests of a different group; since each source lends some support for the high value of intellectual capital, the totality readily convinces that intellectual capital is a long-lived asset whose creation costs theoretically should be capitalized. First, Professor Kahng discusses the efforts of managers to measure intellectual capital in their efforts to "understand and exploit a business's resources and capabilities . . . ."[6] Second, Professor Kahng discusses financial accounting, which parallels the tax system by failing to capitalize self-created intellectual capital; thus, Professor Kahng turns to scholars of financial accounting who argue for reform.[7] Finally, Professor Kahng discusses national accounting for intellectual capital and discusses how reformers have made some inroads in having certain types of intellectual capital included in measuring GDP.[8]

While scholarly writing and industry research within these three sources supports the theoretical case of capitalizing at least some of the costs incurred in producing intellectual capital, there is, however, a clear lack of consensus with respect to how to define intellectual capital, how to measure its value over time, and how to trace creation costs to particular long-lived benefits. As Professor Kahng notes, one of the main objections to capitalization is that the value of much of intellectual property is unknown at its creation and may never be reducible to a particular number.[9] Capitalization of costs further depends on being able to allocate creation costs to long-lived intellectual capital.

Advertising costs can be used to illustrate the problem. Consider a business spending money on various types of advertising campaigns; the costs will encompass campaigns intended to build long-term brand recognition and engage new customers, but they will also include the costs of routine mailings (paper and digital) to remind existing customers of sales.[10] For broader campaigns, the goal of building long-term brand recognition may, of course, not be fulfilled; many advertising efforts fail to

5. *Id.*
6. *Id.* at 2238.
7. *Id.* at 2244–47.
8. *Id.* at 2248–49.
9. *Id.* at 2250, 2271.
10. *See id.* at 2252 (suggesting that some advertising does not, in fact, produce for a company future benefits).

attract consumer attention. Only the costs attributable to advertising yielding benefits lasting longer than at least the year should be capitalized. Other forms of self-created intellectual property involve similar complexities when reduced to practice; it may be clear that businesses intend to create future benefits and may in fact create at least some future benefit, but determining how much of such long-lived benefit has been created and which costs should be allocated to it involves considerable complexity.

Professor Kahng's article suggests a path for bypassing this complexity. She argues that research outside of the tax area could be used to implement "rough justice" rules in the tax area.[11] In the area of national accounting, in particular, significant empirical research has been conducted for the purpose of accurately measuring various forms of intellectual capital.[12] Professor Kahng recommends using that research to impose specific tax capitalization rules.[13] For example, she draws on such research to propose that 50% of advertising costs be capitalized as well as 50% of managerial and executive compensation.[14] Professor Kahng further recommends a uniform five-year recovery period for all capitalized costs for self-created intellectual capital.[15] The use of empirical research on intellectual capital from other disciplines to craft specific tax rules is innovative and clearly worth exploring. Professor Kahng would argue that the current interdisciplinary research is sufficient to enact "rough justice" legislation, and the legislative process could be used to refine the rules as needed. It seems possible, however, that the political process would require supplemental empirical research guided by tax concerns before research on national ranges could be used to impose specific tax rules. Almost certainly, there is high variability across industries as to the types and future value of intellectual capital;[16] one can readily imagine the lobbying that would ensue should Congress propose capitalization of 50% of manager salaries (though it would be amusing to see how lobbyists would couch a deductibility position that depends on demonstrating how executives fail to provide substantial long-term benefits).

Professor Kahng's article is highly persuasive about the main theoretical point—too many of the costs devoted to creating long-lived,

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11. *Id.* at 2271.

12. *See id.* at 2252 (noting that research has focused on the financial services industries but has been sparse).

13. *See id.* at 2274–77 (setting forth proposals for congressional reform, such that Congress would "require that all investments in self-created intellectual capital be capitalized and amortized over a single and fixed time period.").

14. *Id.* at 2275.

15. *Id.* at 2273.

16. *See id.*at 2265 ("The misallocations … will occur unevenly in different sectors of the economy depending on the size and nature of the business, the level of competition in that sector, and many other variables.").

intangible future benefits are being deducted. The use of interdisciplinary research provides needed context for this point and suggests a specific path for moving forward with reform. Professor Kahng's article successfully uses research from outside of tax law to illuminate new paths for scholars and governmental actors to address the tax distortions caused by the "dark-matter" qualities of intellectual capital.[17]

17. *Id.* at 2234; *see also supra* note 1 (explaining use of "dark matter" analogy in Professor Kahng's article).