The Taxation of Ideas

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THERE IS AN OLD SAYING to the effect that all things pleasant are illegal, immoral, or taxable. Ideas — those flashes of inspiration that come to people — are no exception; they are not free from taxation. The ideas of which I speak are not the fugitive thoughts we all have, but fully worked ideas, reduced to practice, and given special legal protection.

The concern of this Research Institute is with ideas in this fully developed stage as intellectual or industrial property. This note comments on one aspect of Federal income taxation on such property.

NATURE OF INTELLECTUAL AND INDUSTRIAL PROPERTY

Intellectual and industrial property, as I use the terms, include writings, compositions, drawings, designs, slogans, and inventions. All of these have in common the fact that they are products of human thought and ingenuity. These physical evidences of intellectual effort are property just as the product of a carpenter's labor is property. Ownership of such property is evidenced by copyrights, trademarks, or patents.

Our legal system in the United States opposes counterfeiting; it therefore attaches considerable importance to giving legal protection to the true originator of intellectual property; for example, to the inventor who first reduces an invention to practice or to the composer who originates a piece of music. The author or inventor gets first claim on the patent or copyright.

A patent or copyright is like a deed to real estate; that is to say, it is tangible evidence of ownership. In economics, we call such paper property rights capital claims. If I borrow money from you and give you my note, you have a capital claim on me. If you license your patent to me, you have a similar capital claim on me. To extinguish these claims, I must repay the borrowed money or pay the patent royalties. If I don't, you are entitled to take legal action agains me.

As economists, we say that capital claims have a circulation inde-

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pendent from that of the capital goods they represent. The mortgage on my house can be bought and sold, pledged and unpledged, even though the house itsself is not involved in any transaction. Similarly your patent may, if you give me an exclusive license, be sublicensed by me even though you are not consulted. If a license is less than exclusive, the situation is different.

If I write a book and copyright it, then make a contract with you, a publisher, to publish it, the copyright belongs initially to me but I may assign all or only a part of my rights to the publisher. If I have a good literary agent, he divides the rights up and sells the book rights to one publisher, the movie rights to another and the serial rights to a third. If you have a good patent attorney, he licenses the American rights to one company, the foreign rights to another. Basically, the literary agent and the patent attorney are in the same business, namely protection and marketing of ideas.

The common feature of all intellectual property is that it may have value. Consequently, the capital claims evidencing ownership of this property may be sources of income. If I publish my book and a few copies sell, both the publisher and I receive income. His is ordinary business income since publishing is his business. Mine is royalty income; writing may be either my business or my hobby. If you license your invention to a manufacturer, he gets ordinary income and you get royalties.

Taxation of Income from Ideas

An unfortunate feature of income in the United States and in most other industrial countries is that it gets taxed. In this country the Federal Government taxes incomes as do most state governments — 36 out of 50 — as well as some localities.

There are two kinds of income; namely, that which recurs every year, and that which is nonrecurring or sporadic. We might call the latter occasional income. I don't write a book every year nor do you always market an invention, unless you are an unusually prolific inventor.

The British income tax, running continuously since 1844, taxes annual income but does not tax sporadic or casual profits. These take a zero rate. The U. S. income tax, running continuously only since 1913, has always taxed both types of income. Casual or nonrecurring profits are called capital gains. Although taxed, they take a lower rate; namely, one half or less than the rate applicable to ordinary income.

Ordinary income is what you get from your trade or business; capital gains come from your hobbies, your investments, etc. In U. S. tax law, capital gains are gains not from trade or business or from selling stock-in-trade, but from other (unspecified) activities.

The Internal Revenue Code defines capital assets, the sale or exchange of which results in capital gains or losses, in the following manner:

> "Capital assets means property held by the taxpayer, whether or not connected with his trade or business, but does not include (1) stock-in-trade of the taxpayer, (2) property used in his business which is subject to an allowance for depreciation, (3) a copyright, literary, musical or artistic composition or similar property held by a taxpayer whose personal efforts created such property, or by a taxpayer in whose hands the basis of such property is determined for the purpose 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 the person whose personal efforts created such property, (4) accounts or notes receivable acquired in the ordinary course of trade or business, (5) an obligation of the United States or any of its possessions, or of a state or territory issued on or after March 1, 1941, on a discount basis."[1]

The Amateur-Professional Tax Distinction

Intellectual property may be produced either as a business or as a hobby. We have professional authors, songwriters, playwrights, designers, and inventors. We also have amateurs in all these fields who just get a lucky idea, and execute it.

Creation of intellectual property is an uncertain business. One may write or invent for years and make very little from it. Suddenly one gets what is known in publishing a "lucky strike." This is not a cigarette but a hit — a best seller — a hit tune — a successful invention. Like the old prospector who finally strikes gold, you have "struck it rich."

As economists, we describe this situation by saying that income from creation of intellectual property is lumpy and discontinuous — big in some years, zero or small in others. Such income is struck with special severity by a progressive income tax. A fluctuating income will owe more tax over 20 years than a steady one of the same size if the rates, exemptions, etc., stay the same. This feature of a progressive income tax is definitely unfair to the recipients of fluctuating income. They are a large group including, in addition to authors, composers, and inventors, professional athletes, actors, cattle ranchers, wheat farmers, and many other occupational and industrial groups.

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[1] Internal Revenue Code, Sec. 1221.

The question is how to fix up the income tax so that fluctuating incomes will not be hurt too badly. Generally speaking, there are both income spreading and income averaging provisions available to do this.

There are two provisions presently in the Internal Revenue Code for mitigating the effect of progressive income tax rates on lumpy income.[2] When compensation is earned for services extending over a period of 36 months or more, the resulting income, instead of being taxed entirely in the year of receipt, may be spread or allocated to the entire period during which the services were performed. This reduces tax liability in many cases. The other provision, which became effective with the Revenue Act of 1964, is an averaging device. It provides that, whenever income from personal services exceeds the average of prior years' incomes from the same source by more than 30 per cent, the tax may be computed by taking one-fifth of the income, calculating the tax, and then multiplying the result by five. This averaging provision has the effect of making the tax rate brackets five times as wide as they would otherwise be for persons who meet the original test of having an unusually high income during a given year to the extent of thirty per cent or more of the previous average. Both provisions are extremely helpful to individuals and corporations having irregular and fluctuating incomes but neither is a full-blown averaging or spreading system such as would be required by strict equitable considerations.

A third possibility for eliminating the effect of progressive taxation on bunched incomes is giving these incomes capital gains treatment; this possibility works because the capital gains tax is imposed at only one-half the rate of tax on corresponding ordinary income. Capital gains treatment makes an appreciable saving to the taxpayer. Moreover, above the point at which the individual income tax rate becomes fifty percent, the rate on capital gains is flat and has no further progression. Therefore, any legislation or regulation which will allow income to be reported as capital gain instead of as ordinary income is extremely valuable to the taxpayer.

Congress has shown a reluctance to cope with the very difficult problems involved in income averaging; it therefore has solved the problem of inequity to the fluctuating income recipient by granting long-terms capital gains treatment to a number of special sources and forms of income. Until a few years ago, there was literally no form of ordinary income, except personal compensation, which could not be converted into capital gains with the exercise of sufficient ingenuity by a skillful

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[2] Both are now included in Sec. 1301.

tax attorney or accountant. Today it is far more difficult to go that route, although the opportunities to convert ordinary income into long-term capital gains have by no means disappeared. They are still possible at many points in the Internal Revenue Code.

Capital gains treatment has been widely used in this country as a form of tax relief to lighten the impact of progressive rates upon bunched-income accounts. One might almost say that this is the primary basis on which capital gains tax treatment has been given out by the Congress during the last two decades.

SUMMARY AND CONCLUSION

We now come to the necessity for summarizing the various ways in which intellectual property is taxed in these United States. These ways may be set down as follows:

1. Gains from writing whether it be books, plays, magazine articles, or newspaper stories, are generally treated as ordinary income. The spreading and averaging provisions do apply so that extreme discontinuities in income from year-to-year can be taken account of.

2. Generally speaking, composing is treated in the same manner as writing. Any royalties from the sale of sheet music, phonograph records, and the like is royalty income and is subject to ordinary income rates of tax, although there have been frequent proposals to change this treatment.

3. Inventions treatreated a little differently than other forms of intellectual property. An invention evidenced by a patent is taxed according to the rule laid down in Section 1235 of the Internal Revenue Code. This section provides, in effect, that when an inventor reduces an invention to practice and secures a patent on it, he may, if he elects to sell all substantial rights, title, and interest to the property by giving an exclusive license for the full remaining period that the patent has to run, obtain capital gains treatment on the proceeds.

This tax rule has been an important source of encouragement to American inventors. This capital gains treatment does not apply to all holders of a patent but only to the inventor and to any investor in the invention before it was reduced to practice. A company employing the inventor does not automatically obtain capital gains treatment when the inventor assigns the patent to his employer, as he may be required to do, by the terms of his employment contract.

I should like to conclude this little dissertation on the economics of intellectual property and in particular on the taxation of the proceeds

from such effort and ingenuity with a question. Is this different tax treatment of the various forms of intellectual property congruent? For example, is it proper that the writer, the composer and the playwright should have to pay the ordinary income rates on the results of their efforts while the inventor should be taxed on a more favorable basis?

In effect, the Congress of the United States has said that inventing is more nearly in the national interest than is writing, composing, or similar artistic accomplishment. This may or may not be the case. One wonders, however, on what basis the Congress decided to make such a determination.

I leave to the reader to draw the moral, if any, from this story.