Please Donate Patents on the Shelf;
Tax benefits can be Focused for Greater Good

By Ron Layton and Peter Bloch

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Over the years, the U.S. government has created a number of different mechanisms to encourage innovative research and development. The granting of patents is one such method. The tax deductibility of patent donations is another.

Through patent donations, companies put inactive but potentially useful intellectual property in the hands of other organizations, mostly universities, that will develop and apply it. As the volume of such donations has grown in the last few years, so has criticism that they have become a vehicle for tax abuse by corporations -- and that the cost to taxpayers is not justified by the benefits. While most of the attention is being focused on the alleged tax abuse, serious discussion about the merits or shortcomings of the underlying policy is lacking.

We conducted an IP donation policy review to better understand the issues and initiate an informed discussion. Under the auspices of the International Intellectual Property Institute [IIPI], and with support from the U.S. Patent and Trademark Office, more than 80 in-depth interviews were conducted with representatives of corporations, universities, and appraisal companies, and with legal experts and economists.

Our findings: Most corporate donors and university recipients stated that, while the program is beneficial, they could only identify nonquantifiable benefits, such as the expansion of university-corporate relationships, the boost to inventor morale, and greater opportunities for faculty. What policy-makers need is more numbers, more facts and more information about transactions so that the effectiveness of the program can be measured.

'ORPHAN' BENEFITS

The basic incentive system for patent donations has been in place for at least 45 years. The Internal Revenue Service confirmed the deductibility of donated patents in 1958. But it was not until the late 1990s that corporate America really began to take advantage of the tax benefit.

In the early '90s, corporate America was increasingly recognizing the value of IP assets. The major accounting firms all launched consulting practices to help corporations catalog and better manage their inventory of patents and other IP. New software was developed to help mine corporate patent portfolios.

One motivation for reviewing IP portfolios was to contain the substantial cost of patent maintenance fees payable to the PTO and to its sister organizations in Europe and Japan. These fees meant that large, innovative companies like the IBM Corp., with tens of thousands of patents, were spending millions of dollars a year on maintenance fees.

As consultants and IP managers studied patent inventories, they were particularly preoccupied with the wasted overhead involved in maintaining "orphan" patents. These were generally defined as patents that:

§ were not consistent with a company's core technologies or mission;

§ were not appropriate for licensing to third parties; and

§ had no value for defensive purposes in competitive markets.

In the case of these orphan patents, consultants made a case for abandonment -- or donation to a nonprofit entity. Donation offered the benefit of an immediate reduction in federal income taxes in that fiscal year [assuming the donor company was profitable]. The first patent donation by a major U.S. company to a nonprofit appears to have been made in 1996 by the Dow Chemical Co. to Case Western Reserve University.

The value of donations has clearly been significant. Speaking for Dow Chemical at a 2001 conference, Rick Gross provided some hard numbers. He said Dow had discovered that "25 percent of our patents had no business value. We downsized the portfolio by over 10,000 patents and saved over $40 million in five years. Additionally, the donation of unused intellectual property has resulted in millions of dollars of tax credits over the past six years."

HARD TO VALUE

It's those millions of dollars in tax credits that have begun to raise eyebrows. Because it is a tax-based incentive, the patent donation process entails a cost to the taxpayer.

IRS rules allow corporations to revalue their patents before donation. The donors are permitted to ignore the patent's book value [which in most cases is zero] and instead estimate the present value of future potential income streams.

Most experts agree that such valuations are extremely subjective and that the resulting appraisals are unreliable, especially where patents are for new processes or products for which reliable comparisons are very hard to identify.

Even companies acting entirely in good faith can find valuation difficult. For instance, an officer at a corporation that has made more than 50 patent donations described an appraisal that had seemed to him excessive. The company then commissioned two more independent appraisals -- only to find that the three appraisals differed by a ratio of 1:2:4. In other words, one appraisal was four times higher than the one with the lowest value.

Add to that the fact that there is little historical data to support valuations. Since most patent donations were not made until the late '90s, and most donated patents required further development, the real value of those first donations is not likely to be known until the second half of this decade.

Moreover, while the extent of appraisal abuse is unknown, survey respondents confirmed its existence.

Given these issues, the cost to the U.S. treasury of patent donations cannot, so far, be justified by any empirical evidence of sufficient economic benefit.

BETTER FOCUS

Yet orphan technologies, whose economic benefits might be lost through abandonment, remain a concern. The current deductibility program does encourage corporations to donate unused technologies. But the system creates price distortions, since donations are made purely for the tax benefits. The IIPI review suggests that it might be time for a more targeted strategy, one that focuses on three criteria:

§ The technologies that are donated have the potential to open wide areas of new application.

§ They are concentrated in sectors with high development costs.

§ Incentives focus on moving a technology forward to the point where final development can be capitalized.

Some observers have argued that the market should choose which research risks to take -- and should absorb the costs of pursuing unproductive avenues. Since no one knows in advance which combination of imagination and research will succeed, any government incentives should encourage many different types of R&D.

This principle suggests that incentives should target technologies in their early to middle stages of development. For technologies in sight of final development and commercial exploitation, the market should be left to complete the financing. In addition, the largest incentives should not be earmarked for technologies with the highest valuation where that valuation reveals that the technology is near market exploitation.

Alternatively, a better option might be to encourage an increase in the number and size of research grants accompanying donated patents, so that universities can have the flexibility to develop donated patents along many different paths. This could be achieved by allowing a higher level of bonus tax deduction for such grants. Corporations should also be encouraged to select more promising technologies for donation -- technologies that might someday produce royalties for donors and recipient institutions alike.

A new incentive structure might provide for a small, simplified tax deduction for patent donations; qualifying processes for recipients; tax incentives for research grants; and royalty participation arrangements that allow corporations to gain from successful exploitation.

Because of the allegations of tax abuse, the existing patent donation system is under threat. The IRS recently started cracking down on donor companies and IP appraisers for taking excessive deductions based on overvalued patents. Congress is considering a tax law change that would limit that deduction to the book value of orphan patents.

But we should not rush to eliminate a policy that encourages invention without considering: What kinds of patent donation policies will increase innovation? What are the likely costs of those policies? What else can be done about the loss of technologies through patent abandonment? Only then can we design a program that best serves the American taxpayer.

Ron Layton and Peter Bloch are IP analysts with Light Years IP, a not-for-profit association. They worked as consultants to the International Intellectual Property Institute on the IP donations report discussed here.

They can be reached at info@lightyearsip.net . Read the IIPI report, "IP Donations: A Policy Review," and related material at www.iipi.org/activities/research.htm.