Charitable Contributions of Patents and Other Intellectual Property

Notice 2004–7

The Internal Revenue Service (IRS) is aware that some taxpayers that transfer patents or other intellectual property to charitable organizations are claiming charitable contribution deductions in excess of the amounts to which they are entitled under § 170 of the Internal Revenue Code. In particular, the IRS has become aware of purported charitable contributions of intellectual property in which one or more of the following issues are present: 1) transfer of a nondeductible partial interest in intellectual property; 2) the taxpayer's expectation or receipt of a benefit in exchange for the transfer; 3) inadequate substantiation of the contribution; and 4) overvaluation of the intellectual property transferred. The purpose of this notice is to advise taxpayers that, in appropriate cases, the IRS intends to disallow all or part of these improper deductions and may impose penalties under § 6662. In addition, this notice advises promoters and appraisers that the IRS intends to review promotions of transactions involving these improper deductions, and that the promoters and appraisers of the intellectual property may be subject to penalties under §§ 6700, 6701, and 6694.

Section 170(a)(1) allows as a deduction, subject to certain limitations and restrictions, any charitable contribution (as defined in § 170(c)) that is made within the taxable year.

However, § 170(f)(3) provides generally that no charitable contribution deduction is allowed for a transfer to a charitable organization of less than the taxpayer's entire interest in property. For example, if a donation agreement states that a transfer to the donee of the taxpayer's interests in a patent is subject to a right retained by the taxpayer to manufacture or use any product covered by the patent, the taxpayer has transferred a nondeductible partial interest in the patent. For other examples of nondeductible partial interests, see Situations 1 and 2 of Rev. Rul. 2003–28, 2003–11 I.R.B. 594.

Generally, to be deductible as a charitable contribution under § 170, a transfer to a charitable organization must be a gift. A gift to a charitable organization is a transfer of money or property without receipt of adequate consideration, made with charitable intent. *See U.S. v. American Bar Endowment*, 477 U.S. 105, 117–18 (1986) (citing Rev. Rul. 67–246, 1967–2 C.B. 104, with approval); *Hernandez v. Commissioner*, 490 U.S. 680, 690 (1989); and § 1.170A–1(h)(1) and (2) of the Income Tax Regulations. A transfer to a charitable organization is not made with charitable intent if the transferor expects a return commensurate with the amount of the transfer. *Hernandez* at 690; *see also American Bar Endowment* at 116.

If a taxpayer receives a benefit in return for a transfer to a charitable organization, the transfer may be deductible as a charitable contribution, but only to the extent the amount transferred exceeds the fair market value of the benefit received, and only if the excess amount was transferred with the intent of making a gift (a "dual character" transfer). *See American Bar Endowment* at 118 (the taxpayer must "at a minimum demonstrate that he purposely contributed money or property in excess of the value of any benefit he received in return.") In other words, the taxpayer must establish that it knew at the time of the transfer that the value of what it gave was greater than the value of what it received. *See id.* In this situation, the burden is on the taxpayer to show that all or part of the payment was a charitable contribution. *See* § 1.170A–1(h). All consideration provided by the charitable organization (other than benefits disregarded under § 1.170A–13(f)(8)) must be taken into account, including non-cash benefits.

For example, if a donation agreement states that the donee assumes a taxpayer's liability for a lease of a research facility, this assumption of liability is consideration from the donee. Likewise, a donee's promise to make available to the taxpayer the results of the donee's research, such as laboratory notebooks, data, and research files, is consideration from the donee. Similarly, a charitable organization's promise to hold a patent and maintain it for a period of time is consideration to a taxpayer if the taxpayer is benefited when others are prevented from purchasing or licensing the patent. *Cf.* Rev. Rul. 2003–28, Situation 3 (taxpayer received no benefit from restriction on donated patent). In each of these examples, the taxpayer has the burden of showing that it knew, at the time of the transfer, that the value of the donated property exceeded the value of the consideration it received from the donee. The taxpayer may deduct no more than this excess amount.

A charitable contribution is allowable as a deduction only if substantiated in accordance with regulations prescribed by the Secretary. Section 170(a)(1) and (f)(8). Under § 170(f)(8), a taxpayer must substantiate its contributions of $250 or more by obtaining from the donee a statement that includes: (1) a description of any return benefit provided by the donee; and (2) a good faith estimate of the benefit's fair market value. (See § 1.170A–13 for additional substantiation requirements.) The IRS intends, in appropriate cases, to disallow deductions if the taxpayer fails to comply with the substantiation requirements. *See, e.g., Addis v. Commissioner*, 118 T.C. 528 (2002).

If all requirements of § 170 are satisfied, including those discussed above, and a deduction is thereby allowed, the amount of the deduction may not exceed the fair market value of the contributed property on the date of contribution (reduced by the fair market value of any consideration received by the taxpayer). *See* § 1.170A–1(c)(1). Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Section 1.170A–1(c)(2). For example, the fair market value of a patent must be determined after taking into account, among other factors: (1) whether the patented technology has been made obsolete by other technology; (2) any restrictions on the donee's use of, or ability to transfer, the patented technology (see Rev. Rul. 2003–28, Situation 3); and (3) the length of time remaining before the patent's expiration.

DRAFTING INFORMATION

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