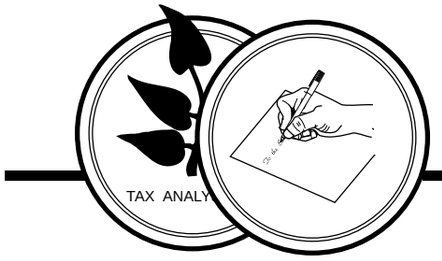

letters to the editor

Observations on Taxation of Infringement Recoveries

To the Editor:

I enjoyed Nicolas Schmelzer's article "Taxation of Patent and Trademark Infringement Litigation Proceeds," *Tax Notes,* Aug. 12, 2002, p. 962. I applaud his admonitions about the importance of tax treatment in this practice area. I have only a couple of observations.

Schmelzer is clearly right to note the enormous importance of *Inco Electroenergy Corp. v. Commissioner,* T.C. Memo. 1987-437, *87 TNT 170-11*. The IRS has long had a knee-jerk reaction to infringement claims (whether patent or trademark), regarding such recoveries as lost profits. For an early case, see *Triplex Safety Glass Co. v. Latchum,* 131 F.2d 1023 (3d Cir. 1942). Given that patents and trademarks generally constitute either capital assets or section 1231 assets, this ordinary income treatment can often be unduly harsh.

Indeed, the remarkable thing about *Inco Electroenergy* is that the Tax Court there paid critical attention to the origin of the claims doctrine, examining the various court filings in the underlying proceedings. Finding that the plaintiff / taxpayer argued about damage to the trademark and goodwill, and never attempted to argue for lost profits, the Tax Court upheld capital treatment. The Tax Court even went so far as to say that the introduction of information and evidence regarding the taxpayer's sales arose only by reason of the taxpayer's attempt to place a value on the damage to the trademark and goodwill.

Thus, a taxpayer may merely use lost profits as an evidentiary factor to determine damage to goodwill. The court in *Inco Electroenergy* found support for the notion that such an evidentiary use did not alter the true basis of the recovery. For this proposition, the Tax Court cited *Raytheon Production Corp. v. Commissioner,* 144 F.2d 10 (1st Cir. 1944), *cert. denied* 323 U.S. 779; and *State Fish Corp. v. Commissioner,* 48 T.C. 465 (1967), *acq.* 1968-2 C.B. 3, *modified* 49 T.C. 13 (1967).

Ultimately, *Inco Electroenergy* suggests an appropriate focus not only on the origin of the claim, but also on the way it is prosecuted. It is the nature of the harm and what is being sought — not how one measures the harm — that should control. Given that the manner in which one calculates damages in litigation is often quite different from the nature of the harm and the origin of the claim, this makes sense.

After all, damages in personal physical injury cases are often calculated at least in part by lost wages. That universal truth certainly does not make the damages taxable as wages. Quite recently, the Tax Court decided *Clarence D. Kightlinger v. Commissioner,* T.C. Memo. 1998-357, *Doc 98-29823 (27 pages), 98 TNT 193-9,* holding that a recovery (in a RICO case) was not excludable under section 104. However, the court examined how damages were calculated, by reference to lost wages and employment-related economic harm. The court pointed out that using economic loss to measure the extent of personal injury does not bar exclusion under section 104 as a matter of law. However, the court also said that the key requirement for the exclusion is the presence of a personal injury, which it did not find on the facts of the *Kightlinger* case.

I expect we will see more controversy about the tax treatment of infringement recoveries. The same measurement phenomenon in an infringement case (how it is measured vs. what it is for) should not be conclusive on the character of the recovery for tax purposes.

Very truly yours,

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August 15, 2002