Patent Infringement Claims and Capital Gain

By Robert W. Wood

Patents and other forms of intellectual property are very important to American and global businesses. Today, intellectual property, from initial filing and protection to licensing and litigation, is an important part of major law firms and corporations. Intellectual property lawyers may once have been thought of as the backroom nerds of the legal profession, not unlike tax lawyers. That is decidedly not so today.

Intellectual property includes patents, trademarks, copyrights, service marks, and trade secrets. It may be easier for patent recoveries to qualify for capital gain treatment, but the others may, too, in appropriate cases.

Types of Intellectual Property Litigation

The tremendous value represented by intellectual property often leads to extraordinary measures to protect it. That protection can be both legal and practical. For example, the secret recipe for Kentucky Fried Chicken’s blend of herbs and spices is under 24-hour surveillance, locked in a safe weighing more than 770 pounds, and located in a vault with 2-foot-thick concrete walls.1

Despite a business’s best efforts to preserve and protect its property, litigation regularly erupts over the scope of that protection and precisely who can do what. Competitors may infringe on patents, trademarks, and copyrights. Employees may leak information or property or depart with valuable trade secrets.

Further, a lawsuit can raise risks of its own. A business seeking damages for patent infringement may quickly find itself defending the patent. Indeed, alleged infringers often seek to defend and justify their actions by asserting that the patent in question is invalid. Also, the tax treatment of the recovery and litigation costs can become much more complicated.

Tax Rules for Litigation Recoveries

Before discussing special tax rules applying to specific types of intellectual property, some tax ground rules are in order. It is a well-worn axiom that the origin of the claim controls the tax treatment of a recovery in or from a lawsuit, whether it is received as a result of a settlement or a judgment.2 To determine the origin of the claim, courts and the IRS ask in lieu of what a recovery was paid.3

A recovery should be taxed in the same manner as the item for which it is intended to substitute.4

1See http://www.kfc.com/about/newsroom/021009.asp.
3See Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir.), cert. denied, 323 U.S. 779 (1944); LTR 200108029, Doc 2001-5469, 2001 TNT 38-23.
4Id.; Knowland v. Commissioner, 29 BTA 618 (BTA 1933).
claims raised in the complaint, litigated, and resolved in a verdict or settlement. Accordingly, if the claim was for lost business profits, then the damage award or settlement payment in lieu of the damage award would be taxable as ordinary income in the same manner as ordinary business profits. The IRS generally views the complaint as the most persuasive evidence of the origin of the claim.6

Section 1235 Treatment

The first and most important way in which litigants may be able to obtain capital gain treatment for some intellectual property recoveries is found in section 1235. Traditionally, the IRS has viewed infringement recoveries as ordinary income.7 However, an infringement recovery may be treated as capital gain if all valuable rights to the patent are (or have been) transferred under section 1235.

Section 1235 allows long-term capital gain reporting without regard to the holding period that generally is required for capital assets. It provides sale or exchange treatment for a transfer of property consisting of all substantial rights to a patent (or an undivided interest) by any qualifying holder of the patent. The transfer cannot be by gift, inheritance, or devise, but beyond that, there are few limitations.

Indeed, statutory sale or exchange treatment applies as if the property were held for more than one year even if it is held for less. Moreover, the sale or exchange treatment applies regardless of whether the consideration of the transfer is payable all at once or periodically over several years, or are contingent on the productivity, use, or disposition of the property.8

Thus, the capital gain treatment provided by section 1235 is extremely broad. There are, however, some key qualifications.

Holder

A common stumbling block to claiming section 1235 treatment is the definition of holder. A holder must be either:

1. an individual whose efforts created the property; or
2. any other individual who has acquired his interest in the property in exchange for money or money’s worth paid to the creator before the actual reduction to practice of the invention, if that individual is neither the employer of the creator nor related to the creator (within the meaning of section 267(b)).

Non-individuals generally do not qualify as holders. Thus, corporations, trusts, estates, and other entities must look outside section 1235 to determine if a transfer of patent rights results in capital gain. However, an exception applies to partnerships.

As with so much else affecting the tax treatment of partnerships, this has enormous practical significance. Although a partnership cannot be a holder per se, that does not mean section 1235 treatment is irrelevant. In fact, each member of a partnership who is an individual may qualify as a holder as to his share of a patent owned by the partnership.9

Even in the case of individual holders, section 267(b) provides rules for constructive ownership of property among family members. In most patent cases I have seen, transfers to family members have not occurred. However, these facts must be explored.

Similarly, relatively few tax disputes seem to arise over the identity of the inventor. But a transfer before an actual reduction to practice can raise issues. In addition to the actual inventor, section 1235 includes as a qualifying holder any individual who acquires the patent from its creator before it is reduced to practice. This “actual reduction to practice” concept is defined by reference to the definition of that term under U.S. patent laws.10

Under title 35 U.S.C. section 102(g), an invention is reduced to actual practice when it has been tested and operated successfully under operating conditions. That may occur either before or after application for a patent, but cannot occur later than the earliest time commercial exploitation of the invention occurs.

Transfer of All Substantial Rights

Another issue that arises under section 1235 is whether the taxpayer transferred all substantial rights to the patent. The Treasury regulations issued under section 1235 provide that all substantial rights to a patent means “all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an individual interest therein) are transferred.”11

Thus, a transfer of all substantial rights would not occur if the grant of rights were limited geographically, limited in duration by the terms of a transfer to a period less than the remaining life of the patent, limited to a particular field of use within

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7See Mathey v. Commissioner, 177 F.2d 259 (1st Cir. 1949), aff’d 10 T.C. 1099 (1948), cert. denied, 339 U.S. 943 (1950).
8Reg. section 1.1235-2(d)(2).
9See reg. section 1.1235-2(e).
10See reg. section 1.1235-2(b).
a trade or industry, or covers less than all the claims or inventions covered by the patent. All pertinent facts and circumstances are considered.12

Examples of rights considered not substantial include the retention of legal title for the purpose of securing performance or payment by the transferee in the grant of an exclusive license. Similarly, the retention of rights in property that is not inconsistent with the passage of ownership (such as a security interest or a forfeiture condition for non-performance) would not be considered substantial.13

The right conferred by a patent grant is, according to the statute, “the right to exclude others from making, using, or selling” the invention.14 Accordingly, if the patent holder intends to transfer all substantial rights, he must transfer his entire right to exclude others (including himself) from making, using, and selling the invention. The inadvertent failure to specify each of those rights in the grant clause of the license agreement can result in the denial of capital gain treatment.15

All substantial rights are measured by what the transferor has left, not by what is given up.16 Whether all substantial rights have been transferred is a qualitative test, and each retained right must be examined separately, and collectively with other retained rights, to determine if the transferor has retained too much.17

Courts have held that a prior nonexclusive license to an unrelated party can prevent capital gain treatment.18 Moreover, retained rights can be a problem.19

Payments for Infringement

The breadth of section 1235 is demonstrated by the fact that the capital gain treatment it affords may also apply to payments for infringement (and to payments in the nature of a settlement for infringement). The regulations under section 1235 are explicit that if section 1235 applies to the transfer of a patent, amounts received in settlement of (or as the award of damages in) a suit for compensatory damages for infringement of that patent are considered payments to which capital gain treatment applies.20

The applicability of section 1235 is to be resolved by reference to the nature of the interest transferred and whether the proceeds of the lawsuit (whether by settlement or judgment) are attributable to the transfer of rights. The Treasury regulations imply that not only payments from the transferee of rights, but also damages from a third-party infringer, can qualify for long-term capital gain treatment.21

Capital Gain Treatment Outside Section 1235

Often, section 1235 treatment is simply not available. Section 1235 applies only to transfers by holders who are individual inventors or who have acquired their interest from unrelated individual inventors before the patent was reduced to practice. Initial corporate ownership, for example, is a bar to section 1235 treatment. The regulations indicate that acquisition of a patent from a non-holder carries a taint, even in the hands of someone who would otherwise qualify as a holder.22

But outside the confines of section 1235, capital gain treatment is still possible. A patent may be a capital asset in the hands of the recovering plaintiff. If it is, and if the holding period was greater than one year, settlement of the case may effect a sale or exchange of the patent. A settlement payment would then be received free of tax to the extent of the taxpayer’s basis in the patent, with the excess being subject to tax at long-term capital gain rates.

Nonprofessional Inventor

A patent can qualify as a capital asset in much the same way that an investment asset would. If an inventor tinkers at home in the evening and not as required by his employer, how could a resulting patent be anything but a capital asset? The answer is that at a certain point, producing and selling patents can become a full-time occupation.

That has tax consequences. As with other areas in which the scope and frequency of activities can bear on their tax treatment, a person who is a professional may experience different tax results. Some courts have had to consider whether an inventor’s activities rise to the level of a profession.

For example, in Kucera v. Commissioner,23 the Tax Court held that an inventor with 21 inventions and several patents was not a professional. Although he was apparently an inveterate tinkerer, only one of

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12See further detail in reg. section 1.1235-2(b).
13See reg. section 1.1235-2(b)(2).
16Fawick v. Commissioner, 436 F.2d 655 (6th Cir. 1971).
18General Aniline and Film Corp. v. Commissioner, 139 F.2d 759 (2d Cir. 1944); Bell Intercontinental Corp. v. United States, 381 F.2d 1004 (Ct. Cl. 1967).
20Reg. section 1.1235-1(c)(1).
21Id.
22Reg. section 1.1235-1(c)(3).
23T.C. Memo. 269 (1951).
his patents was sold and commercially viable. He had never been employed as an inventor, and the court held that as a nonprofessional, he was entitled to report his gain as capital.

In contrast, in *Lockhart v. Commissioner*, the court considered an inventor who had a string of 37 patents over a 19-year period. Noting that this inventor had taken leaves of absence from his other employment, the court considered him a professional.

Of course, if one is seeking capital gain benefits outside the scope of section 1235, one does not want to be classified as a professional inventor. A patent holder's holding period is considered to begin when the patent has been reduced to practice. Reduction to practice has been defined as "a demonstration that the inventor's idea works." This is the same test as that often arose based on the professional/amateur distinction. However, that analysis is still relevant for any transfer of a patent by a holder who does not qualify under section 1235.

**Holding Period**

Favorable capital gain rates are generally available only if the seller has owned the asset continuously for more than one year. A patent holder's holding period is considered to begin when the patent has been reduced to practice. Reduction to practice has been defined as "a demonstration that the inventor's idea works." This is the same test as in the section 1235 regulations, which provide that actual reduction to practice cannot occur later than the earliest time that commercial exploitation of the invention occurs.

**Transfers of Patents**

Similar to the requirements of section 1235, the courts have held that a transfer of all the substantial rights in a patent qualifies the transferor for capital gain treatment. A transfer of anything less is a license subject to tax at ordinary income rates. Whether a transfer constitutes a sale or license is determined by the substance of the transaction, taking into account the parties' agreement and the surrounding circumstances.

No particular form or terminology is required. Instead, the distinction between a sale and a license depends on the legal effect of the transfer instrument. A transferor of a patent need not transfer all his rights for the transaction to qualify as a sale or exchange.

The key question is whether the transferor has retained any rights that, in the aggregate, have substantial value. The value of any retained rights is a factual issue. For example, in *E.I. du Pont*, the Third Circuit affirmed the district court's finding that the transferor's retained rights had no substantial value, and consequently were not a bar to capital gain treatment.

The Sixth Circuit in *Kavanagh* held that the transfer of a nonexclusive license may also qualify for capital gain treatment. Although the transferor retained the right to use and transfer the patent, the court held that the transaction was a sale and not a mere license, noting that the agreement ran for the full term of the patent and that consideration for the assignment was paid in a lump sum, not as royalties. *Kavanagh* has been questioned in several cases, and the First Circuit has disapproved of it. Accordingly, the IRS may argue that a transferor who retain the right to use the patent should not be allowed capital gain treatment.

**Effect of Settlement Agreement**

Ideally, the settlement agreement in a patent case will explicitly transfer all rights to the subject patent. However, many will not, particularly when tax counsel is not involved in the settlement. Nevertheless, a reasonable argument can often be made

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24 58 F.2d 343 (3d Cir. 1958).
25 Section 1221(a)(1).
27 Section 1222(3).
29 Id.
30 See reg. section 1.1235-2(e).
32 Id.
33 *Bell Intercontinental Corp. v. United States*, 381 F.2d 1004, 1011 (Cl. Ct. 1967).
34 *E.I. du Pont*, 432 F.2d at 1055.
35 *Kavanagh v. Evans*, 188 F.2d 234, 236 (6th Cir. 1951).
36 *E.I. du Pont*, 432 F.2d at 1055.
37 The rights appeared to be substantial on their face and included the following: (i) the right to import into Brazil nylon lawfully manufactured elsewhere; (ii) the right to control any subsequent licensing or assignment of the rights granted Rhodiaceta and CBR with respect to the use of the patented process and apparatus in making nylon; (iii) the right to make any use it saw fit (including manufacturing under its own auspices, licensing, sale, etc.) of the patent rights in connection with dacon; and (iv) the right to manufacture for sale the apparatus covered by the patent or to license others to manufacture the apparatus for use, in connection with the manufacture of fibers other than nylon (especially dacon).
that the settlement effectively conveyed substantially all the plaintiff’s existing rights to the patent that existed at the time of the settlement.

In some cases, that argument may be strengthened if the patent expired during the litigation. Thus, it is possible that the plaintiff may have no remaining rights in the patent at the time of the settlement. Under the holdings of E.I. du Pont and Kavanaugh, the retention of rights that do not have any substantial value is not a bar to capital gain treatment.

However, some settlements could be considered grants of nonexclusive licenses. In First National Trust and Savings Bank of San Diego, the IRS argued that a transfer subject to prior nonexclusive licenses is not eligible for sale or exchange treatment.\(^\text{39}\) In that case, the court agreed with the IRS that a transfer of an exclusive license, subject to a previously granted license, does not constitute a transfer of a capital asset.

The court went on to state that whether “the end result of such latter conveyance may accomplish a divestiture of all substantial rights which the transferor had in the patent at the time, is not the proper criterion.”\(^\text{40}\) Other courts, however, have held that the prior transfer of a nonexclusive license does not preclude a later sale to a third party.\(^\text{41}\)

**Inclusion of Attorney Fees**

If a plaintiff is recovering money in an intellectual property suit, it may be doing so with a contingent fee lawyer. Often, therefore, the question is raised over how the attorney fees should be treated. That can even be the primary tax worry of the plaintiff, because the tax treatment of attorney fees can lead to harsh results.

The Supreme Court has held that plaintiffs must generally include in gross income their attorney fees in contingent fee litigation.\(^\text{42}\) Often, that means they must content themselves with claiming miscellaneous itemized deductions for their attorney fees. The primary rationale of Banks is the assignment of income doctrine.

The Supreme Court reasoned that the client, not the attorney, has ultimate control over the claim, including decisions whether to settle. Thus, under the general rule of Banks, a contingent fee arrangement giving the attorney a percentage interest in the recovery does not allow the plaintiff to exclude the attorney’s fee from income. Instead, the plaintiff is required to include and then deduct the payment to the attorney as a cost of producing that income.

For business taxpayers filing a corporate, partnership, or S corporation return, this usually causes no harm, because a full business expense deduction should be available. Even a Schedule C taxpayer paying fees to carry on a trade or business suffers no additional tax by reason of the Banks rule. However, a taxpayer claiming only a miscellaneous itemized deduction for the fees usually faces limitations on the deduction as well as alternative minimum tax.

**Capitalization of Legal Fees**

Fortunately, a plaintiff recovering in a patent case who is entitled to capital gain treatment also solves his attorney fee problem. After all, if the recovery is capital, the legal fees normally must also be treated as capital. That should mean they can be offset against the recovery on the taxpayer’s Schedule D.

The effect of including the attorney fees in the plaintiff’s gross income depends on whether the settlement payment is ordinary income or capital gain. The origin of the claim test is used to determine the tax treatment of the payment of legal fees.\(^\text{43}\) Whether legal fees can be deducted or must be capitalized is controlled by the nature of the matter for which the expenses were incurred.\(^\text{44}\)

Section 263(a) denies a deduction for any amounts expended for permanent improvements or betterments “made to increase the value of any property or estate.” Although legal fees are not highlighted in that language, the regulations make clear that the cost of capital expenditures includes the cost of defending or perfecting title to property.\(^\text{45}\) The regulations further provide that expenses paid or incurred in recovering property constitute part of the cost of the property and are therefore not deductible.\(^\text{46}\)

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\(^\text{40}\) Id. at 282.
\(^\text{41}\) See General Aniline and Film Corp. v. Commissioner, 139 F.2d 759, 760 (2d Cir. 1944) ("Nor does it seem to us important, in such a context, that the assignor, before making the assignment, had granted to others some rights under the patent"); MacDonald v. Commissioner, 55 T.C. 840, 859 (1971) (declining to follow First National Trust, on the basis that “the issue of whether all substantial rights have been transferred (that is, whether there has been a sale) should arise only when the transferor has retained rights of some sort” (emphasis added)); Bell Intercorporational Corp. v. United States, 381 F.2d 1004, 1013-1014 (Ct. Cl. 1967) (criticizing the reasoning of First National Trust).

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\(^\text{44}\) United States v. Gilmore, 372 U.S. 39, 49 (1963); FSA 200228005, Doc 2002-16265, 2002 TNT 135-16 (“the deductibility of the payments and legal fees at issue depends on the origin of the claim from which the settlement arose”).
\(^\text{45}\) Reg. section 1.263(a)-2(c).
\(^\text{46}\) Reg. section 1.121-1(k).
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In the past, the IRS contended that attorney fees in patent infringement litigation should be capitalized rather than deducted. The Tax Court agreed with the IRS, but the Third Circuit reversed.\textsuperscript{47} The IRS appears to have accepted the Third Circuit’s decision, allowing deductions when the validity of the patent is not in question.\textsuperscript{48}

According to the IRS, whether an amount is paid to defend or perfect title, on one hand, or to protect against infringement, on other, is a factual matter.\textsuperscript{49} That general proposition seems true enough. However, because patent infringement cases almost invariably involve a challenge to the patent’s validity, it is hard to see how the legal fees in pursuing a patent infringement claim that is eligible for capital gain should be anything other than capital expenditures.

As the IRS argued in field service advice:

A patent is intended to grant the inventor “the exclusive right” to their invention for a limited time so as to “promote the progress of science and useful arts.” U.S. Constitution, Art. I, section 8, cl. 8. It is a valuable property right — albeit intangible. In litigating a patent infringement action, it must be recognized that the first defense of the alleged infringer is almost invariably that no valid patent exists. Acknowledging this legal and practical backdrop to patent litigation makes clear that patent infringement actions are actions that essentially defend or perfect the right to the patent monopoly. Given that recognition, the subject taxpayer’s legal costs should be presumed capital in the first instance.\textsuperscript{50}

Moreover, claiming a sale of a patent would surely suggest capitalization of the related legal fees. For example, in Leigh v. United States,\textsuperscript{51} the taxpayer entered into an agreement to sell stock of a manufacturing company. The deal soured, culminating in litigation between buyer and seller.

The court found that the buyer’s suit originated from the taxpayer’s disposition of stock and that the stock was a capital asset. It therefore required the taxpayer to capitalize the legal fees under section 263. Courts and the IRS also have held that legal fees must be capitalized when they bear a direct relationship to an asset acquired or preserved by a lawsuit.

For example, in Lange v. Commissioner,\textsuperscript{52} a taxpayer sought to deduct legal fees in litigation over his ownership interest in a closely held company. The Tax Court rejected the deduction, holding that the fees must be capitalized. After all, the origin of the claim was to protect, defend, and acquire ownership interests in the corporation.

Similarly, in Winter v. Commissioner,\textsuperscript{53} the Tax Court held that taxpayers must capitalize legal fees incurred in a lawsuit seeking damages arising from an increased purchase price of a capital asset.\textsuperscript{54} Although the relationship arises outside the field of intellectual property litigation, the IRS seems to recognize the fundamental symbiosis between the nature of legal matters relating to capital assets and the capitalization of the legal fees. In FSA 200228005, the taxpayer paid legal fees to prosecute an action arising from its purchase of contaminated land. The IRS said:

Taxpayer incurred legal fees in its efforts to obtain recovery for the environmental damage to the Purchased Property that was allegedly caused by [the defendant]. Therefore, those legal fees should be treated as capital expenditures.\textsuperscript{55}

Whether capital gain for a patent recovery is being claimed under section 1235 or outside its confines, related legal fees should generally be capitalized. They are treated as capital expenditures made with respect to the sale or exchange of the asset and applied to increase the plaintiff’s basis in the patent. When capital gain treatment is being claimed, it is simply consistent to do so.

Treatment by Payer

Throughout the litigation settlement arena, the manner in which the payer treated an amount paid can be relevant to the characterization of the payment to the payee for tax purposes. That is one of the reasons that securing an agreement on those issues among the parties to litigation is so important. In that context, it would seem self-evident that if a payer treated the amount as payment for the purchase of patent rights, then that would be one indication that section 1235 (or capital gain treatment more generally) may apply.

\textsuperscript{47}Urquhart v. Commissioner, 215 F.2d 17 (3d Cir. 1954), rev’g 20 T.C. 944.
\textsuperscript{50}1997 FSA LEXIS 435, *6-8. See also FSA 199925012, Doc 1999-22012, 1999 TNT 123-23 (noting that in spite of the lack of later IRS challenge to Urquhart, “whether the necessary litigation of the patent’s validity is in essence tantamount to defending or perfecting its ‘title’ to the grant of patent monopoly is open to debate”).
\textsuperscript{51}611 F. Supp. 33 (N.D. Ill. 1985).
\textsuperscript{52}T.C. Memo. 1998-161, Doc 98-14273, 98 TNT 87-13.
\textsuperscript{53}T.C. Memo. 2002-173, Doc 2002-17047, 2002 TNT 141-10.
\textsuperscript{54}See also Spector v. Commissioner, 71 T.C. 1017 (1979), rev’d and remanded on another issue, 641 F.2d 376 (5th Cir. 1981).
\textsuperscript{55}Doc 2002-16265, 2002 TNT 135-16.
Conversely, if the payer treated (and reported) the payment as a payment of royalties, without any mention of the transfer of patent rights, that would surely seem to dictate against capital gain treatment. Nevertheless, there are arguments that the intent of the payer in this context may be less relevant than with many other types of litigation. After all, the question whether all substantial rights to a patent have been transferred is a factual determination based on the substance, rather than any specific form of the transaction.56

That seems true outside section 1235, but it seems especially true within it. Indeed, in addition to the regulations under section 1235, several cases suggest that section 1235 should be liberally interpreted, giving the capital gain treatment it affords far-reaching application.57

Conclusion

There is much debate about capital gains rates, even whether capital gains should be taxed at all. Nevertheless, it seems likely that our system will remain largely intact and that the tax rate preference that has been the primary impetus for taxpayers to seek capital gain treatment will also remain. Given the large dollars that can change hands in legal settlements over patents and other forms of intellectual property, there can be large tax dollars hanging in the balance.

56See E.I. du Pont, 432 F.2d at 1055.

57See, e.g., Gilson v. Commissioner, T.C. Memo. 1984-447.