PERSPECTIVE

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Patent suit recovery: ordinary or capital?

By Robert W. Wood

Patents and other intellectual property are of enormous importance to American and to global businesses. If we didn't already know that, the *Apple v. Samsung* verdict and its worldwide headline news should bring the point home. From initial filing, licensing, litigation and sale, billions turn on these issues. Intellectual property lawyers may once have been thought of as backroom nerds. Today, they are legal lions.

And if billions turn on these issues, enormous tax consequences do too. It is not merely an academic question whether a patent recovery is ordinary income or capital gain. You'll care if one type of income is taxed at 35 percent and the other at only 15 percent. Surprisingly, a case about stolen intellectual property can be either ordinary income or capital gain.

First note that only individuals and flow-through entities (like S corporations, partnerships and limited liability companies) benefit from capital gain treatment. Regular corporations (C corporations), pay the same tax rate no matter what. If Apple ever collects its landmark infringement verdict against Samsung, it won't be entitled to capital gain rates.

The first and most important way IP recoveries can be capital gain is under Section 1235 of the tax code. It expressly allows long term capital gain reporting for a transfer of all substantial rights to a patent (or an undivided interest) by any qualifying holder. Amazingly, unlike capital gain rules for holding stock or real estate, no one year holding period is required.

Plus, payments can still qualify if made over time or made contingent on the productivity, use or disposition of the property. Thus, this capital gain treatment is extremely broad. It can apply to payments for infringement and for settling infringement.

However, a transfer of all rights means all rights. Even inadvertent wording glitches can prevent capital gain treatment. That makes language in settlement agreements terribly important.

Capital Gain Outside Section 1235. 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. Yet all is not lost if you can't meet the terms of Section 1235. Even outside of Section 1235, capital gain treatment may still be possible.

A patent can qualify as a capital asset in much the same way as investment property. For example, suppose that an inventor tinkers at home in the evening. If he produces a patented invention, the resulting patent is a capital asset. However, some inventors may be viewed as professional, making their recoveries ordinary income.

That's what the IRS argued unsuccessfully in *Kucera v. Commissioner*, T.C.M. (RIA) ¶51090. The Tax Court held that an inventor and inveterate tinkerer with 21 inventions and several patents was still not a professional so was entitled to capital gain treatment. In contrast, in *Lockhart v. Commissioner*, 258 F.2d 343 (3d Cir. 1958), the inventor had 37 patents over a 19-year period and was ruled a professional. Section 1235 was enacted to eliminate fact-intensive disputes about the professional/amateur distinction. However, outside of Section 1235 the extent and nature of an inventor's efforts are still relevant to the capital versus ordinary issue.

If a patent is a capital asset in the hands of the recovering plaintiff, and if the holding period was greater than one year, a settlement can "sell" the patent. A patent holder's holding period begins when the patent has been reduced to practice. Reduction to practice has been defined as a demonstration that the inventor's idea works. A settlement payment would be free of tax up to the taxpayer's basis in the patent. The excess would be taxed as long-term capital gain.

The courts have held that a transfer of all of the substantial rights in a patent qualifies for capital gains treatment. *E.I. du Pont de Nemours and Co. v. U.S.*, 432 F.2d 1052, 1055 (3d Cir. 1970). A transfer of anything less is a license subject to tax at ordinary income rates. The key question is whether the transferor has retained any rights with substantial value. *E.I. du Pont,* 432 F.2d at 1055.

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Settlement Agreement. Ideally, the settlement agreement will explicitly transfer all rights to the patent. If it does not, it may still be arguable that the settlement conveyed substantially all of the plaintiff's rights to the patent. How the payor treats the payment is also relevant. If a payor treats the payment as made to purchase patent rights, it helps to support capital gain treatment.

Conversely, if the payor treats (and reports) the payment as "royalties" without any mention of the transfer of patent rights, it sounds ordinary. Even so, whether all substantial rights to a patent have been transferred is a factual question.

As this short summary reveals, the tax stakes in ending an intellectual property dispute can be even larger than in many other types of disputes. The tax issues alone can be enormous. The potential for good planning — or for big mistakes — is too big to ignore.

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