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Apple Samsung Verdict Reversed, But How About Taxes?

The U.S. Court of Appeals for the Federal Circuit has reversed part of a \$930 million verdict Apple won in 2012 against Samsung Electronics. Apple's \$930 million judgment included \$382 million for 'trade dress' dilution. Trade dress is a legal term for a trademark on the way a product is packaged or presented. That part of the verdict was reversed and sent back to the trial court.

The appeals court said the features Apple sought to trademark were not eligible for this kind of legal protection. The jury found Samsung violated several Apple patents, including those related to iPhone's design and appearance. Despite Apple's 2012 victory and this 2015 setback, Apple was not successful in getting the court to ban the sale of the infringing Samsung phones. Yet they are now no longer on the market.



(Photo credit: Wikipedia)

Arguing that the damages awarded to Apple were excessive and unprecedented, the appeal found Samsung arguing that it should not be forced to pay a high price for basic features including a "rectangular, round-cornered, flat-screened, touch-screened phone." With the legal and procedural wrangling that will continue, it is unclear how many dollars Apple will end up actually collecting. But the case is just one of many intellectual property fights facing tech companies and inventors both large and small. Companies of all sizes engage in IP fights. Even little guys, mom and pop companies, and inventors can get embroiled in disputes, as plaintiff or defendant.

From initial filing, licensing, litigation and sale, billions of dollars turn on patents, and that means taxes. If Apple ever collects its millions, it is ordinary income, and if Samsung ever pays, it is tax deductible. But smaller companies often worry whether their patent recovery is capital gain taxed at lower rates. For individuals and pass-through entities (S corporations, partnerships and limited liability companies), the tax rate difference is big.

One way patent recoveries can be capital gain is via [Section 1235](#) of the tax code. It says a qualifying holder's transfer of all substantial rights to a patent is long term capital gain. Amazingly, no one-year holding period is required. Payments over time or contingent on the patent's productivity qualify too.

Even payments for infringement can qualify. However, there must be a transfer of all rights to the patent. Also, the transfer must be by holders who are individual inventors or who acquired their interest from unrelated individual inventors before the patent was reduced to practice.

What if you don't qualify for Section 1235? Capital gain is still possible. Say a non-professional inventor tinkers evenings and invents something. The resulting patent is a capital asset, while professional inventors earn ordinary income. That leads to line-drawing.

For example, in [Lockhart v. Commissioner](#), an inventor with 37 patents over 19 years was ruled a professional. In contrast, in [Kucera v. Commissioner](#), an inventor with 21 inventions and several patents was not a professional so was entitled to capital gain. In fact, Section 1235 was enacted to eliminate these fact-intensive disputes.

Yet outside of Section 1235, the distinction between professionals and amateurs is still relevant. Capital gain should be possible if a patent is a capital asset, it is held for more than one year and the settlement agreement sells the patent. The holding period begins when the patent has been "reduced to practice," defined as a demonstration that the idea works. Ideally, the settlement agreement will explicitly transfer all rights to the patent.

A transfer of anything less is a license. Thus, where rights are retained, a key question is whether they have substantial value. It also helps if the payor records the payment as for the purchase of patent rights. If the payor reports the payment as "royalties paid" without mentioning a transfer of patent rights, it sounds ordinary.

One piece of advice? If you're hoping to qualify for capital gain treatment, get some advice before you sign. Another? Don't get into a fight with Apple or Samsung.

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