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Big Winner in Apple v. Samsung and Other IP Suits? IRS

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From initial filing, licensing, litigation and sale, billions turn on patents, and that means taxes. But can a patent recovery ever be capital gain taxed at 15% rather than 35%? Surprisingly, yes.

First, only individuals and pass-through entities (S corporations, partnerships and limited liability companies) benefit from capital gain. C corporations don't. That means when Apple collects its landmark infringement verdict against Samsung, it won't be entitled to capital gain rates. But private companies organized as LLCs or S corporations are different. One way patent recoveries can be capital gain is via §1235. 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 §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. Thus, in *Lockhart v. Comr.*,[1] an inventor with 37 patents over 19 years was ruled a professional. In contrast, in *Kucera v. Comr.*,[2] an inventor with 21 inventions and several patents was not a professional so was entitled to capital gain. In fact, §1235 was enacted to eliminate these fact-intensive disputes. Yet outside of §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.

Bottom line? If you're hoping to qualify for capital gain treatment, get some advice before you sign.

For more information, in the Tax Management Portfolios, see Reddy, 558 T.M., Intellectual Property: Exploitation and Disposition, *and in Tax Practice Series, see ¶1720, Transfers of Patents, Know-How, Franchises, Trademarks and Trade Names.*

[1] T.C. Memo 1957-114.

[2] 10 T.C.M. 303 (1951).