PERSPECTIVE

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# Capital gains in patent cases: When is a recovery not taxed as ordinary income?

By Robert W. Wood

Suits for the infringement of patents or other intellectual property are usually asking for lost royalties, the stream of payments that the inventor would have collected but for the infringement. Most people—even those who know very little about taxes—are likely to say that a stream of royalties is probably taxed as ordinary income. Of course, that is right, a stream of royalty payments is clearly ordinary income.

How then could the resolution of a patent dispute result in capital gain? After all, capital gain usually involves selling something. Still, it is sometimes possible for inventors to be positioned to treat patent litigation settlement proceeds as capital gain. The tax savings can be big too.

It is true that in (high tax) California, ordinary income and capital gain are taxed at the same rates, up to 13.3%. But some inventors don't live here, and some inventors who do move out shortly before a settlement! When it comes to the IRS, there are still big savings between ordinary income and capital gain, usually the difference between 37% and 23.8%.

So capital gain is decidedly better if you can get it. It is worth thinking beyond patents too. Although it is often easier to report patent recoveries as capital gain, other intellectual property recoveries may also qualify in appropriate cases.

Since the 1950s, the definition of "capital asset" in the tax code has excluded most forms of intellectual property (*other* than patents) if it is "held by a taxpayer whose personal efforts created such property." As an example, this rule applies to copyrights. As a result, an author who spend a couple of years writing a book cannot sell his or her rights and report long-term capital gain.

Starting in 2018, the Tax Cuts and Jobs Act expanded the list of exclusions from capital gain treatment in section 1221(a)(3) of the tax code, so that its exclusion now applies to patents and inventions that are the product of a taxpayer's personal efforts. Congress made parallel changes to section 1231(b)(1)(C), so that "property used in the trade or business" does not include patents or inventions, either.

This means that an inventor's gain from the sale or exchange of a patent or invention used in a trade or business cannot qualify as long-term capital gain under section 1231(a)(1). Although Congress prevented patents and inventions from qualifying as capital or quasi-capital assets in the hands of their inventors, it did not close the door on capital gain. In fact, Section 1235 of the tax code is still there, and still works just fine.

Section 1235 of the tax code still allows a "holder" to report profits from the transfer of all substantial rights to a patent as long-term capital gain. The tax code defines a "holder" to include "any individual whose efforts created such property." That means inventors can still report capital gain in connection with qualifying transfers.

Not surprisingly, the IRS has traditionally viewed *infringement* recoveries as a substitute for royalties and hence as ordinary income. Under section 1235, however, the inventor's recovery is treated as capital gain if it is paid in connection with a transfer of all substantial rights to the patent, or to an undivided interest in the patent. If a settlement agreement provides for the requisite transfer of all substantial rights to a patent or an undivided interest, the inventor can report long-term capital gain.

The definition of "holder" is important, and it even includes certain early-stage investors who purchase an interest in the property from the inventor. However, corporations, partnerships, trusts, estates, and other entities generally do not qualify as holders for this purpose. Even so, there is a partial exception for partnerships.

An individual partner can still qualify as a holder with respect to his or her *share* of a patent owned by the partnership. That means that, when you might receive a K-1 for your share of a partnership or LLC recovery, you might still qualify for capital gain treatment on your share of the case proceeds. One of the key issues under section 1235 is whether the inventor has transferred "all substantial rights" to the patent or to an undivided interest in it.

Still, the breadth of section 1235 is demonstrated by the fact that capital gain treatment can apply to payments for infringement. To determine whether a particular recovery qualifies, it is necessary to consider 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 wording of a settlement agreement is not binding on the IRS when it considers the tax effects of the payments.

Nevertheless, the wording of the settlement agreement is always considered by the IRS. And as a practical matter, having good wording in the settlement agreement can often spell the difference between a short audit and a long one, or between a positive or negative tax result. So, paying attention to the tax issues at settlement time is plenty important.

Ideally, the settlement agreement in a patent case will explicitly "transfer" all rights to the subject patent, whether by sale or license. How about the tax treatment of the legal fees? In a contingent fee case, for tax purposes, the plaintiff is treated as receiving 100% of the proceeds, even if the lawyer is separately paid his or her 40% by the defendant. The U.S. Supreme Court issued an opinion on this point in 2005 in *Commissioner v. Banks*, 543 U.S. 426 (2005).

That tax case upsets plenty of plaintiffs in a wide variety of types of cases. Since 2018, many plaintiffs have been unable to deduct their legal fees unless they qualify as expenses of carrying on a full-blown trade or business. When capital gain for a patent recovery is being claimed under section 1235, however, 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.

Fortunately, an inventor whose patent recovery is entitled to capital gain treatment should usually also solve his or her attorney fee problem at the same time. After all, if section 1235 treats the recovery as proceeds from the sale or exchange of a capital asset, the related legal fees must normally *also* be treated as capital. You can think of it like a selling expense.

If paying your lawyer 40% enabled you to sell your patent, you get to offset your legal fees against your recovery. This reduces the seller's taxable income by as much as a full deduction no matter what the plaintiff's circumstances. In short, in many patent and other intellectual property cases, inventors and other holders should think about their tax rates.

It is a little harder to do this now, given the tax changes that were enacted in 2018. However, section 1235 is still in the tax law and it still works. Indeed, in addition to the helpful regulations under section 1235, a number of tax cases say that section 1235 should be liberally interpreted. The case law even suggests that the capital gain treatment it affords should be accorded far-reaching application. See, for example, *Gilson v. Commissioner*, T.C. Memo 1984-447 (1984).

The way remains open for inventors to structure their infringement recoveries to generate long-term capital gain. Given the large dollars that can change hands in patent settlements and verdicts, inventors should sweat the details of any settlement with that in mind.

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