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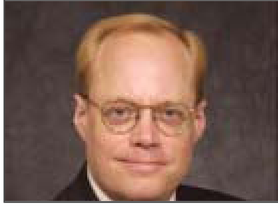

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Taxing Apple's $119.6 Million Patent Verdict Against Samsung

Apple's jury verdict against Samsung is only the latest episode of the patent slug-fest between the two tech giants. Apple accused Samsung of violating smartphone patents, though to a smaller extent, Apple was found to have infringed Samsung patents too. While $119.6 million is nothing to sneeze at, it's a tiny fraction of the $2.2 billion Apple sought. In 2012, a different jury ordered Samsung to pay Apple $930 million, but Samsung has appealed.

It isn't just companies like Apple and Samsung that engage in these high-stakes IP fights. Even little guys, mom & pop companies and inventors can get embroiled too, as plaintiff or defendant. From initial filing, licensing, litigation and sale, *billions* of dollars turn on patents, and that means taxes.

Iphone4 and NexusS (Photo credit: Kai Hendry)

If Apple ever collects its millions, it is ordinary income, and if Samsung ever pays, it's deductible. But smaller companies often worry whether their patent recovery is capital gain taxed a lower rates. For individuals and pass-through entities (S corporations, partnerships and limited liability companies) the 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 continent 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.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.