

# Taxing the Kardashians' Recovery in Recent IP Infringement Lawsuit

By Robert W. Wood

Sisters Kourtney, Kim and Khloe Kardashian won their suit for royalties from the makeup line Kardashian Beauty. After a five-year legal battle, a California State Appeals Court judge agreed that the Kardashians were owed \$11.5 million in royalties from Haven Beauty and subsidiary Hillair Capital. The payments were due under a license deal for the beauty line that included various beauty items sold in stores. The award adds \$2 million in post-judgment interest and costs.

The Kardashians were owed a \$1 million advance plus ongoing fees, but when they were shorted millions, they sued. The trial court ruled for the Kardashians in 2018, and the Appeals court upheld it. When the amount is paid, of course, there will be taxes to consider too. The IRS and the state of California will collect their shares, which will be sizable.

This was a royalty dispute, and royalties are taxed as ordinary income. In contrast, a sale of intellectual property can sometimes be entitled to more favorable capital gain rates. Under current rates, capital gain tops out a 23.8%, while ordinary income taxes are 37%. Both ordinary income tax rates and capital gain are slated to go up under President Biden's proposals. In fact, Biden would retroactively double capital gain tax. Paying up to 43.4% in capital gain tax sounds crushing.

Most legal settlements are taxed, but the treatment varies depending on how you were damaged, how the case was resolved, how checks and IRS Forms 1099 were issued and more. Suits for the infringement of patents or other intellectual property usually ask for lost royalties, a stream of payments that the holder would have collected but for the infringement. Most people are likely to say that a stream of royalties is taxed as ordinary income.

And they are usually right. Amazing, though, some patent infringement damages can be taxed as capital gain. Although capital gain usually means selling something, it is sometimes possible for inventors to treat patent litigation settlement proceeds as capital gain. It's just one of many of the quirky tax rules surrounding how lawsuit recoveries are taxed. Whether you settle or win a judgment, taxes apply in most cases. You can influence how your recovery is taxed by how you deal with these issues. Tax jockeying at lawsuit settlement time is common.

Starting in 2018, the list of exclusions from capital gain treatment grew. Presently, an inventor's gain from the sale of a patent or invention used in a trade or business cannot qualify as capital gain under one provision. However, 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 IRS has traditionally viewed infringement recoveries as ordinary income. Still, and inventor's recovery is 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.

One of the key issues is whether the inventor has transferred "all substantial rights" to the patent or to an undivided interest in it. 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.

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 under *Commissioner v. Banks*, 543 U.S. 426 (2005). 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. However, an inventor whose patent recovery is entitled to capital gain treatment should usually also solve the attorney fee problem at the same time.

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.

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 its capital gain treatment should be accorded far-reaching application. See, for example, *Gilson v. Commissioner*, T.C. Memo 1984-447 (1984). Thus, some inventors can still 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.

The Kardashians will surely have ordinary income, and they will surely be able to deduct their legal fees, probably as business expenses. After all, the deduction for legal fees if you are in business is still sacrosanct. In fact, that has caused some plaintiffs reporting legal settlements to argue that their lawsuit was itself a business. That argument usually fails, unless there really is a business.

The tax treatment of legal fees can be particularly alarming. In most cases, a Form 1099 will say you got 100% of the money, even if 40% went directly to your lawyer. Since 2018, many legal fees can no longer be deducted, so plaintiffs can be taxed on 100% with no tax deduction for their legal fees. The math can seem bizarre, even in physical injury cases. If your case is fully nontaxable (say an auto accident in which you're injured), that won't cause any tax problems.

But if your recovery is taxable, watch out. Say you settle a suit for intentional infliction of emotional distress against your neighbor for \$100,000, and your lawyer keeps \$40,000. You might think you'd have \$60,000 of income. Instead, you'll have \$100,000 of income, and you may not be able to deduct the \$40,000 at all. That's why many clients say

they are paying tax on money (the lawyer's fees) they never received. It can leave you scrounging for ways to deduct legal fees even under the new tax law.

But if your case involves claims against your employer or for other defined forms of unlawful discrimination, there's an "above the line" deduction for legal fees. But outside of employment or other unlawful discrimination litigation, watch out. There are sometimes ways of circumventing these rules, but you'll need sophisticated tax help before your case settles to do it. As for the Kardashians, they needn't worry, but many less well-heeled plaintiffs should be careful.

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