ALSTON + BIRD LLP

Federal Tax Advisory

MAY 1, 2010

Insights Into Recent Regulatory, Judicial and Legislative Developments

Atlanta
Charlotte
Dallas
Los Angeles
New York
Research Triangle
Silicon Valley
Ventura County
Washington, D.C.

Deferring Taxation of Patent Infringement Damages

ILM 201008035, as modified by ILM 201013037

When a patent infringement dispute is resolved by an agreement or judgment directing the infringer to pay a sum to the winner, attention often turns to the infringer's tax deductions and the winner's income tax liability. *THIS IS TOO LATE*. Tax considerations should play some role in fashioning the terms of payment, if possible. Although a lump sum immediate payment is hard to turn down, it leaves little flexibility as to taxation: the winner will owe tax immediately . . . unless, as shown below, the terms of settlement provide that the payment is for some future benefit. Tax choices increase when the payment is deferred. Also, deferred payments may be the only practical way to collect, and may be consistent with the grant of rights for future use.

A recently issued IRS ruling on a patent litigation settlement by a major taxpayer provides interesting insight into a deferral possibility that likely was planned by the winner in fashioning its settlement. ILM 201008035, as modified by ILM 201013037.

Facts

The parties settled their lawsuit and executed a settlement term sheet in Year 1. Later in Year 1, the winner performed its obligation under the term sheet by granting a retroactive license to the infringer that obligated the infringer to make payments for past and future use of the winner's patent rights. The infringer made all of the payments in Year 2, which included $X amount for infringer's prior sales and $Y amount as prepaid royalties for the remaining three years of the license. Thus, the winner got no cash in hand in Year 1, and got all of the cash and other payment it was going to get in Year 2, but part of the payment it received in Year 2 was for license rights to be used by the infringer in Year 3 (and perhaps later). How will the winner be taxed?

Analysis

The most logical answer might seem to be that the winner will report all of the payments it receives in Year 2 in its Year 2 tax return. That is wrong, on two counts.

As to $X amount, the winner will have to report and pay tax in Year 1 even though the winner will not receive the payment until Year 2. This is because an accrual method taxpayer (which most businesses are) must report income on the *earlier of* (1) receipt; (2) performance of the service, etc., that makes the taxpayer entitled to a future payment; or (3) the legal due date of the payment. Because $X amount was for prior infringement that the infringer became obligated to pay in Year 1, that amount was taxable in Year 1, even though the winner had not received the payment.

However, the $Y amount will be taxed in Year 3, even though it was received in Year 2 and the infringer became obligated to pay it in Year 1. This is good for the winner. Cash receipt without immediate tax liability is always a desirable outcome: the winner gets to use 100 percent of the $Y amount for up to a year, before having to pay up to 40 percent of it out to the IRS and state DOR.

Jack Cummings
Editor

The Atlantic Building
950 F Street, NW
Washington, DC 20004-1404
202.756.3300
Fax: 202.756.3333

www.alston.com

This advisory is published by Alston & Bird LLP to provide a summary of significant developments to our clients and friends. It is intended to be informational and does not constitute legal advice regarding any specific situation. This material may also be considered attorney advertising under court rules of certain jurisdictions.

One of the FORTUNE
"100 Best Companies to Work For®"

The One-Year Deferral Rule

You can thank Alston & Bird for this outcome. The code allows certain income deferral in cases of sales of goods; about 40 years ago, the IRS extended to service providers a method to use a one-year deferral under certain terms—but there was a lot of confusion about what was a service. For example, the licensing of a patent might not look like a service and it certainly was not a sale of goods.

One of the firm's clients, Barnett Banks, had an issue with the IRS over whether a payment was for a service and thus deferrable; in Barnett's case, it was not a royalty but, rather, annual credit card fees that did not look to the IRS like service fees. As a result of litigation pursued by Philip Cook, Terry Greene and Tim Peaden, the Tax Court ruled in 1996 that the fees were for services and the deferral applied.

Seven and a half years later, the IRS issued a revised procedure for the one-year deferral that had previously been limited to service providers, and extended it to licensors of intellectual property, including copyrights, patents, trademarks, service marks, trade names and similar intangible property rights (such as franchise rights and arena naming rights). Although there are many detailed rules controlling the use of this one-year deferral method, the key requirement is that the taxpayer has received an advance payment that it treats as income in the later year for financial accounting (non-tax) purposes.

Conclusion

The treatment of the payments received by the victorious patent holder in CCA 201008035 may not be intuitive: part is taxed before payment is received and part is not taxed even though payment is received. The former result may be unavoidable on facts like these; the latter illustrates an opportunity to add value for the client.

For additional information, contact Terry Greene (404) 881-7493 or Sam Kaywood (404) 881-7481.

Expensing Royalty Fees

Robinson Knife Manufacturing Co. v. CIR, 105 AFTR 2d 2010-XXXX (2d Cir. 2010)

This recent decision allowed the immediate deduction of license royalty payments as they accrued on the sale of the licensed inventory, rather than requiring the royalties to be capitalized into inventory. The decision rejected the Service's deficiency assessments, which would have shifted about 10 percent of the royalty payments into ending inventory for this FIFO taxpayer.

The key to obtaining the current deductions were the facts that (1) the license agreements made the royalties payable only upon the taxpayer's withdrawal of the licensed products from inventory for sale, not upon their manufacture; and (2) the royalties were a percentage of the sale price. Trademark licensing agreements of the sort at issue in the Robinson case are very common. However, the particular terms describing when payments are due vary widely.

- Licensees who have been capitalizing such royalties should examine their agreements to determine whether the royalties can be expensed.
- Licensees who have the flexibility to revise their royalty agreements to meet the standards of the Robinson test should do so.
- Licensors should be cooperative in providing such royalty agreements, because tax savings to the licensees can benefit the licensors.

For additional information contact John Baron (704) 444-1434 or Clay Littlefield (704) 444-1440.

All regular monthly and "Special Alert" issues of the *Federal Tax Advisory* can be viewed on our Web site at **www.alston.com** under Resources or contact us at **taxgroup@alston.com**.

Federal Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481

Edward Tanenbaum
Co-Chair
212.210.9425

John F. Baron
704.444.1434

Henry J. Birnkrant
202.756.3319

Robert T. Cole
202.756.3306

Philip C. Cook
404.881.7491

James E. Croker, Jr.
202.756.3309

Jasper L. Cummings, Jr.
919.862.2302

Tim L. Fallaw
404.881.7836

Terence J. Greene
404.881.7493

Brian D. Harvel
404.881.4491

Michelle M. Henkel
404.881.7633

L. Andrew Immerman
404.881.7532

Brian E. Lebowitz
202.756.3394

Clay A. Littlefield
704.444.1440

Tola Ozim
212.210.9533

Vivek Patel
404.881.7686

Timothy J. Peaden
404.881.7475

Matthew A. Stevens
202.756.3553

Gerald V. Thomas II
404.881.4716

Charles W. Wheeler
202.756.3308

ALSTON & BIRD LLP

© Alston & Bird LLP 2010