INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Index (UIL) No.: 1341.00-00; 1341.02-00
CASE MIS No.: TAM-116393-98 February 24, 1999

District Director

Number: **199923003**
Release Date: 6/11/1999
Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Year Involved:
Date of Conference:

LEGEND:

Taxpayer =

Inventory =

Plaintiff =

X =

Year 1 =

Year 2 =

Year 3 =

Award =

TP Case =

ISSUE

Whether a taxpayer is entitled to the benefits of § 1341 of the Internal Revenue Code (Code) upon the payment of damages in a patent infringement lawsuit.

FACTS

From Year 1 through Year 2, Taxpayer engaged in the manufacture of Inventory, included gross receipts (proceeds) from the sale of Inventory on its federal income tax returns, and paid the federal income tax due. In Year 1, Plaintiff brought suit against Taxpayer, alleging that Taxpayer's manufacture and sale of Inventory infringed certain patents of Plaintiff and therefore violated 35 U.S.C. §§ 271(a) and (b). Section 271(a) provides that "whoever without authority makes, uses, offers to sell, or sells any patented invention ... infringes the patent." Section 271(b) provides that "[w]hoever actively induces infringement of a patent shall be liable as an infringer."

In Year 2, the United States District Court for X entered judgment against Taxpayer, finding that Taxpayer had infringed certain patents of Plaintiff. Pursuant to 35 U.S.C. § 284 which authorizes damages for patent infringement, the district court subsequently made an award of damages resulting from the infringement. Section 284 provides that "the court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer, together with interest and costs as fixed by the court."

In Year 3, Taxpayer paid the amount awarded to Plaintiff. On its federal income tax return for Year 3, Taxpayer applied § 1341 of the Code and attached the following statement to Form 1120: "The Taxpayer has calculated its [Year 3] tax under Section 1341(a)(5) (Claim of Right) based upon a settlement with [Plaintiff]. The principal amount subject to Section 1341(a)(5) is $[Award]."

LAW & ANALYSIS

Section 1341 of the Code provides that a taxpayer is entitled to the benefits of the section if (1) an item was included in the gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to the item; (2) a deduction is allowable for a subsequent taxable year because it was established after the close of the prior taxable year (or years) that the taxpayer did not have an unrestricted right to the item or to a portion of the item; and (3) the amount of the deduction exceeds $3,000.

Section 1.1341-1(a)(1) of the Income Tax Regulations (Regulations) provides that a taxpayer is entitled to the benefits of § 1341 of the Code if the taxpayer is entitled to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right.

Section 1.1341-1(a)(2) of the Regulations provides that "income included under a claim of right" means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item, and "restoration to another" means a restoration resulting because it was established after the close of the prior taxable year (or years) that the taxpayer did not have an unrestricted right to all or a portion of the item included in gross income. See, e.g., Van Cleave v. United States, 718 F.2d 193 (6th Cir. 1983) (corporate officer restored excessive compensation); Coon v. United States, 87-1 USTC 9150, 59 AFTR

2d 645 (S.D. W. Va. 1987) (former shareholder restored assets received on liquidation); Rev. Rul. 78-25, 1978-1 C.B. 270 (former shareholder restored assets received on liquidation).

A taxpayer is not entitled to the benefits of § 1341 upon the payment of an item that was not included in the taxpayer's gross income for a prior taxable year. See Kraft v. United States, 991 F.2d 292 (6th Cir. 1993) (employee's restitution payment not an item previously included in employee's gross income); Bailey v. Commissioner, 756 F.2d 44 (6th Cir. 1985) (employee's restitution payment not an item previously included in employee's gross income); Maier Brewing Co. v. Commissioner, T.C.M. 1987-385, aff'd, 916 F.2d 716 (9th Cir. 1990) (compensation for use of assets not an item previously included in payor's gross income); Uhlenbrock v. Commissioner, 67 T.C. 818 (1977) (addition to tax not an item previously included in payor's gross income).

In the present case, Taxpayer was ordered to pay damages to Plaintiff because of Taxpayer's infringement. In patent infringement nomenclature, what the patent holder loses by the infringement is damages; what the infringer makes by the infringement is profits. Aro Manufacturing Co. v. Convertible Top Replacement Co., 377 U.S. 476 (1964). The Court in Aro Manufacturing stated that the difference between a patent holder's "damages" and an infringer's "profits" is an "important distinction." Aro Manufacturing, at 505. Under 35 U.S.C. § 284, a patent holder is entitled to damages, and not to the infringer's profits made from the sale of inventory in violation of the patent. General Motors Corp. v. Devex Corp., 461 U.S. 648 (1983); Aro Manufacturing, at 507; Marvel Specialty Co. v. Bell Hosiery Mills, Inc., 235 F. Supp. 218 (W.D.N.C. 1964).

In 1946, the statutory precursor to 35 U.S.C. § 284 was revised to eliminate the recovery of the infringer's profits and to provide for only the recovery of damages suffered by the patent holder. Aro Manufacturing, at 505-507. Legislative history for this change provides that Congress intended to eliminate the need to compute the infringer's profits when computing the damages to be recovered by the patent holder because computing the infringer's profits was frequently very difficult and time consuming. See H. R. Rep. No. 1587, 79th Cong., 2d Sess. 1-2 (1946); S. Rep. No. 1503, 79th Cong., 2d Sess. 2 (1946); 92 Cong. Rec. 9188 (1946) (remarks of Sen. Pepper); General Motors Corp.,at 654; Georgia-Pacific Corp. v. U.S. Plywood Corp., 243 F. Supp. 500 (S.D.N.Y. 1965).

The patent holder's damages under 35 U.S.C. § 284 have been defined as "compensation for the pecuniary loss [the patent holder] has suffered from the infringement, without regard to the question whether the [infringer] has gained or lost by his unlawful acts." Aro Manufacturing, at 507. Determining damages based on how much the patent holder has suffered as a result of the patent infringement requires an analysis of "what would Patent Holder-Licensee have made" if there had been no infringement. Aro Manufacturing, at 507.

The district court in TP Case, in determining the damages to be awarded to

Plaintiff patent holder as a result of Taxpayer's infringement, referenced Aro Manufacturing and stated it must determine the sales and profits lost to Plaintiff patent holder because of Taxpayer's infringement. The court further stated that although 35 U.S.C. § 284 states that the damage award shall not be "less than a reasonable royalty," the purpose of this alternative is not to provide a simple accounting method, but to set a floor below which the courts are not authorized to go. Thus, the court first determined (to the extent it could) the lost profits of Plaintiff as a result of Taxpayer's infringement. To arrive at the lost profits portion of the damages judgment, the court looked to proof of the following by Plaintiff patent holder: (1) demand for the patented product; (2) absence of acceptable noninfringing substitutes; (3) its manufacturing and marketing capability; and (4) the amount of profit it would have made. See Panduit Corp. v. Stahlin Bros. Fibre Works, 575 F.2d 1152 (6th Cir. 1978). To the extent the court could not determine Plaintiff's lost profits, the court determined a reasonable royalty. The court then added the two amounts (lost profits and a reasonable royalty) together to arrive at Plaintiff's damages – what Plaintiff patent holder would have made if Taxpayer had not infringed.

Initially, Taxpayer asserts that, because the district court calculated Plaintiff's damages by taking into account the number of Taxpayer's Inventory sales from Year 1 through Year 2, the court must have awarded to Plaintiff the proceeds from those sales. We disagree. The district court recognized that damages payable under 35 U.S.C. § 284 are equal to the amount of Plaintiff's lost profits (or to the amount of a reasonable royalty when those lost profits are less than the amount of a reasonable royalty or when those lost profits cannot be determined). Lost profits, as discussed above, are what a patent holder would have made if the infringer had not infringed. Del Mar Avionics, Inc. v. Quinton Instrument Co., 836 F.2d 1320 (Fed. Cir. 1987); Saginaw Products Corp. v. Eastern Airlines, Inc., 615 F.2d 1136 (6th Cir. 1980). In order to establish its lost profits, a patent holder is required, in part, to prove that during the relevant period there was a demand for the patented product in the market. See Panduit Corp., at 1156. Plaintiff and Taxpayer operated in a two-seller market for Inventory. Thus, proof of total demand for Inventory required Plaintiff to prove the number of Taxpayer's Inventory sales during the relevant period (Year 1 through Year 2). The district court considered the number of Taxpayer's Inventory sales in order to determine total demand for Inventory in the marketplace. Further, demand for Inventory is just one of four elements (as discussed in the preceding paragraph) that the court considered in determining Plaintiff patent holder's lost profits because of Taxpayer's infringement. See Panduit Corp., at 1156. Even though the number of Taxpayer's Inventory sales were included as probative of Plaintiff's lost profits, the evidentiary use of that data is "a far cry" from a rule that an infringer's profits are equal to the damages recoverable by the patent holder in a patent infringement lawsuit. See Georgia-Pacific Corp., at 528. It is not the infringer's profits that are recoverable, but rather the patent holder's lost profits that are recoverable. Aro Manufacturing, at 507.

The amount of Plaintiff's lost profits, as calculated by the district court, represents a portion of the total damages awarded to Plaintiff. However, the court also concluded that Plaintiff had not proved lost profits in connection with all of Taxpayer's infringing sales of Inventory. Therefore, as the measure of damages suffered when Plaintiff's lost profits could not be proved, the court calculated a reasonable royalty.

Next, Taxpayer asserts that (1) the portion of the total damages award computed on the basis of a reasonable royalty should be characterized as a royalty, and (2) § 1341 applies to the payment of a royalty. We disagree with both of these royalty assertions. First, a reasonable royalty is merely a floor below which the damages award under 35 U.S.C. § 284 cannot fall. Even though a portion of the damages award may contain an amount computed on the basis of a reasonable royalty, the award is characterized as damages and not as a royalty.

However, even if 35 U.S.C. § 284 authorized the payment of a royalty to a patent holder, the payment of a royalty does not warrant the application of § 1341. A licensor does not include in its gross income royalties payable to a licensee, even though the royalties may be calculated with reference to the sale proceeds that the licensor includes in its gross income. The connection between royalties paid by a taxpayer and sale proceeds received by the taxpayer is at best indirect, just like the payment of any other business expenses, and does not involve the restoration of an item that was included in gross income, as is required for the application of § 1341. See Cal-Farm Insurance Co. v. United States, 647 F. Supp. 1083 (E.D. Calif. 1986) (payment of expenses not an item previously included in gross income). Taxpayer's payment of a royalty (damages) to Plaintiff is not a restoration of the proceeds that Taxpayer received from the sale of Inventory. There is no assertion that the purchasers of Taxpayer's Inventory made erroneous or excessive payments to Taxpayer at the time of those Inventory sales. Taxpayer not only appeared to have an unrestricted right to those sale proceeds, but actually did have an absolute right to those proceeds in the absence of a purchaser's claim to the contrary. Therefore, Taxpayer's payment of damages (a portion of which was computed on the basis of a reasonable royalty) does not, as required for application of §1341, constitute the restoration of an item (Taxpayer's sale proceeds) that was included in gross income for a prior taxable year. See First Nat'l Bank of Elkhart County v. United States, 330 F. Supp. 975 (N.D. Ind. 1971) (additional salary payment not an item previously included in payor's gross income); § 1.1341-1(a) and (h) (payment of legal fees not an item previously included in payor's gross income).

Finally, Taxpayer asserts that, even if the payment of damages in a patent infringement lawsuit is not a restoration of an item that was included in Taxpayer's gross income, § 1341 applies to Taxpayer's payment of damages because § 1341 does not require the restoration of the same item that was previously included in gross income. Taxpayer cites several authorities in support of its position. First, Taxpayer cites the example under §1.1341-1(h) of the Regulations, which reads as follows:

> **Legal fees and other expenses.** Section 1341 and this section do not apply to legal fees or other expenses incurred by a taxpayer in contesting the restoration of an item

> previously included in income. This rule may be illustrated by the following example:
> Example. A sold his personal residence to B in a prior taxable year and realized capital gain on the sale. C claimed that under an agreement with A he was entitled to a 5-percent share of the purchase price since he brought the parties together and was instrumental in closing the sale. A rejected C's demand and included the entire amount of the capital gain in gross income for the year of the sale. C instituted action and in the taxable year judgment is rendered against A who pays C the amount involved. In addition, A pays legal fees in the taxable year which were incurred in the defense of the action. Section 1341 applies to the payment of the 5-percent share of the purchase price to C. However, the payment of the legal fees, whether or not otherwise deductible, does not constitute an item restored for purposes of section 1341(a) and [§ 1.1341-1(a)].

Taxpayer asserts that the item included in A's gross income (gain on a sale) is not the same item paid by A in a subsequent year. Taxpayer characterizes the item subsequently paid by A as a "broker's fee" even though the example expressly states that the item paid by A is a 5-percent share of the "purchase price." We disagree with Taxpayer's characterization.

The agreement between A and C in this example specifically provided for the division of the purchase price from the sale of A's residence: A was entitled to a 95 percent share and C was entitled to a 5 percent share. C obtained a judgment that A had wrongfully withheld a portion of the purchase price. A paid the judgment. The amount paid was a 5 percent share of the purchase price, which was an item previously included in A's gross income. Therefore, A correctly applied § 1341 to the payment. This analysis of the example in §1.1341-1(h) is consistent with § 1.1341-1(a) because the item subsequently paid by A to C is a portion of the purchase price -- the same item that was previously included in A's gross income. Thus, the example does not support the argument of Taxpayer that the restored item was different from the item previously included in gross income.

Our analysis of the example in § 1.1341-1(h) is similar to court's analysis of the transaction in Killeen v. United States, 63-1 USTC 9351,11 AFTR 2d 1072 (S.D. Cal. 1963). In Killeen, an agreement between a manufacturer and a designer provided for the division of profits realized from the sale of a new product. The designer later obtained a judgment that the manufacturer had wrongfully withheld a portion of the profits. The manufacturer paid the judgment. The amount paid was profits which was an item previously included in the manufacturer's gross income. Therefore, the manufacturer correctly applied § 1341 to the payment. See Maier Brewing Co. for a similar analysis of both the §1.1341-1(h) example and Killeen. In both the § 1.1341-1(h) example and Killeen, the items restored were the same items that were previously included in gross income.

The second authority cited by Taxpayer is Coon, where a sole shareholder received a liquidating distribution from Company. It was later determined that Company had outstanding liabilities and that a portion of the shareholder's previously received distribution was subject to the liabilities. The shareholder provided the funds for payment of the liabilities, and the court allowed the shareholder to apply § 1341 due to the restoration of the liquidating distribution. Taxpayer asserts that the item included in gross income (a liquidating distribution) was not the same item paid in a subsequent year. Taxpayer characterizes the item restored as a payment in satisfaction of Company's debts.

We think that Taxpayer correctly characterizes the item included in gross income as "a liquidating distribution," but Taxpayer mischaracterizes the restorative payment in the subsequent year. The shareholder's subsequent payment in Coon restored a portion of the very same liquidating distribution that was included in the shareholder's gross income in a prior year because that portion of the liquidating distribution was subject to Company's liabilities. Thus, the case satisfies the requirement of §1341 that the item restored must be the same item as was previously included in gross income. See Rev. Rul. 78-25 (assets received by shareholder on liquidation restored to pay corporate liabilities).

CONCLUSION

Although Taxpayer previously included proceeds from the sale of Inventory in the computation of its gross income, Taxpayer was not required, and could not have been required, to disgorge to Plaintiff any profits from those sales. Instead, 35 U.S.C. § 284 required Taxpayer to pay damages to Plaintiff to compensate Plaintiff for Plaintiff's lost profits suffered as a result of Taxpayer's patent infringement. Taxpayer's payment of damages to Plaintiff does not constitute a restoration of the proceeds that Taxpayer received from the sale of Inventory. Thus, we conclude that Taxpayer is not entitled to the benefits of § 1341 because Taxpayer's payment of damages in a patent infringement lawsuit is not a restoration of an item that was included in Taxpayer's gross income for a prior taxable year.

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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