INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director, Field Operations

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

District Court =

Patentholder =

Unit =

Year 1 =

Year 3 =

Year 8 =

Year 11 =

Year 15 =

Year 17 =

Year 20 =

Amount $1 =

Amount $2 =

Amount $3 =

Amount $4 =

Amount $5 =

Amount $6 =

Amount $7 =

Amount $8 =

Month 1 =

ISSUE

Whether Taxpayer is eligible for the benefits of section 1341 for the payment of damages in a patent infringement lawsuit.

FACTS

From Year 1 to Year 17, Taxpayer produced and sold over Units amounting to sales in excess of Amount $1. In Year 8, Patentholder filed a patent infringement lawsuit in District Court. In its lawsuit against Taxpayer, Patentholder alleged that Taxpayer's manufacture and sale of the Units infringed certain patents of Patentholder and therefore violated 35 U.S.C. section 271.

Under 35 U.S.C. 271 (2001), whoever without authority makes, uses, offers to sell, sells or imports any patented invention, infringes the patent. Under 35 U.S.C. 284 (2001), damages for patent infringement are an amount 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.

The District Court determined that Taxpayer did not infringe upon Patentholder's patents. On appeal, the District Court's ruling was reversed. Ultimately Taxpayer was ordered to pay Patentholder the sum of Amount $2 constituting damages and pre-judgment interest in the respective amounts of Amount $3 and Amount $4. The District Court further ordered that the court files be sealed. In the fiscal year ending Month 1 Year 20 (FYE Year 20), Taxpayer paid the amount awarded to Patentholder. Taxpayer claims that the damages paid to Patentholder are based upon a reasonable royalty.

For FYE Year 20, Taxpayer allocated the damages on an annual basis to tax years Year 3 through Year 15 and computed its income tax liability by applying section 1341(a)(5) for the tax years Year 3 through Year 11, the years of the infringement for which the rate applicable for FYE Year 20 was different from the rates applicable for those years. In applying section 1341, Taxpayer determined its tax liability for FYE Year 20 to be Amount $7. Without the benefit of section 1341, Taxpayer's liability for FYE Year 20 would have been Amount $8.

LAW

Section 1341(a) of the Code provides that if an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item; a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item, and the amount of such deduction exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the tax for the taxable year computed with such deduction, or the tax for the taxable year computed without such deduction minus the decrease in tax under this chapter for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

Section 1.1341-1(a)(1) of the Income Tax Regulations provides that a taxpayer is entitled to the benefits of section 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. Also this section provides that the phrase "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.

ANALYSIS

1. Whether Taxpayer is entitled to a deduction with respect to the damages payment

Section 162(a) provides that a taxpayer may deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Amounts a taxpayer pays as civil damages arising out of the ordinary conduct of its business are generally deductible under section 162(a). Helvering v. Hampton, 79 F.2d 358, 390 (9th Cir. 1935). In the context of patent infringement litigation, the Sixth

Circuit observed that "when an infringer is required to pay damages to a design patentee, the amount so paid is deductible from his income tax." Schnadig Corp. v. Gaines Manufacturing Co., 620 F.2d 1166 (6th Cir. 1980). In the present case, Taxpayer's damage payment for patent infringement satisfies the general requirements of section 162(a) because Taxpayer is in the business of manufacturing and selling Units, the acts of patent infringement arose directly out of the conduct of its business, and the damage payment was both an ordinary and necessary expense.

Taxpayer alleges that the payment of patent infringement damages is deductible under section 165 as losses, rather than as ordinary and necessary business expenses under section 162(a). Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. There is no specific test to distinguish a loss under section 165 from an ordinary or necessary business expense under section 162(a). However, in the present case, taxpayer's damage payment satisfies the ordinary and necessary requirement of section 162(a). Also, case law does not support the taxpayer's argument that the damage payment constitutes a loss under section 165. Becker Brothers v. United States, 7 F.2d 3 (2nd Cir. 1925), cited by taxpayer, is contrary to the weight of authority, and consequently, unpersuasive. Taxpayer's situation is factually distinguishable from Becker Brothers for two reasons: (1) the question of whether the damages were properly characterized as an inventory cost was not at issue in Becker Brothers; the case involved the question of whether the damages could even be taken into account in computing taxable income; and (2) the damages paid by Taxpayer were not based on Taxpayer's profits but a reasonable royalty.

Section 162(a) business deductions are "subject to the exceptions provided in part IX (section 261 and following relating to items not deductible)." Under section 261, no deduction is allowed for costs described in section 263A. Section 263A requires a taxpayer to include in inventory costs all direct and indirect costs associated with the production of property that is inventory in the hands of the taxpayer. Direct and indirect costs must be included in inventory costs under section 263A even though these costs would otherwise be deductible under some other section of the Code, e.g., section 162 for ordinary and necessary business expenses. Section 1.263A-1(c)(4) provides that "[c]osts that are capitalized under section 263A are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer." (Emphasis added.) Direct and indirect costs for which a deduction would be allowed absent the applicability of section 263A are not "deducted" but "recovered" through cost of goods sold.

Section 1.263A-1(e)(3)(ii)(U) provides that the indirect costs required to be included in inventory costs under section 263A include royalties incurred in securing and maintaining the right to use a manufacturing procedure associated with property produced. In Plastic Engineering v. Commissioner, T.C. Memo. 2001-324, the taxpayer

failed to allocate any payments made under a royalty agreement to inventory costs. Instead, the taxpayer deducted the entire amount. The Tax Court held that royalty payments incurred for the use of a patent are indirect costs of the goods manufactured using the patent, and therefore subject to the uniform capitalization rules under section 263A.

According to Taxpayer's factual assertion, the patent infringement damages in this case are based upon a reasonable royalty. Since the amount of the damages are based upon a reasonable royalty without regard to the infringer's profits, the damages are analogous to a royalty for the use of a manufacturing procedure. Royalties for the use of a manufacturing procedure associated with property produced must be included in inventory costs. See §1.263A-1(e)(3)(ii)(U); Plastic Engineering, *supra*. Because the patent infringement damages incurred by Taxpayer are analogous to a royalty payment for the use of a manufacturing procedure associated with property produced by Taxpayer, the damages must be included in inventory costs under section 263A.

In order for section 1341 to apply to the payment of an item, a deduction must be allowable for the item. Section 1341(a)(2). Since these damages must be included in inventory costs under section 263A, they are not deducted, but instead are recovered through cost of goods sold. See §1.263A-1(c)(4). As a result, section 1341 does not apply to the patent infringement damages paid by Taxpayer.

Taxpayer argues that the patent infringement damages are deductions for purposes of applying section 1341 because cost of goods sold is a deduction from gross income, and to retroactively capitalize inventory costs would be inconsistent with the matching principles underlying section 263A. In support of its position, Taxpayer quotes from Plastic Engineering. According to the Tax Court's summation of the Service's argument, the Service "contends that the royalty payments incurred by petitioner are subject to the capitalization rules of § 263A, and ... that the payments must be deducted over time through ... cost of goods sold." Plastic Engineering, T.C. Memo. 2001-324 (emphasis added). However, the Service did not argue in Plastic Engineering, and we do not interpret the court's statement as holding, that cost of goods sold is a deduction. As stated above, costs included in inventory under section 263A are not "deducted" but are "recovered" through costs of goods sold.

2. Section 1341(b)(2) inventory exception

Even if Taxpayer was entitled to a deduction with respect to the patent infringement damages payment, Taxpayer would be precluded from obtaining the benefits of section 1341 by the inventory exception of section 1341(b)(2).

Section 1341(b)(2) provides that section 1341 does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Section 1.1341-1(f)(1) of the regulations provides "section 1341 and this section do not apply to deductions attributable to items which were included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. This section is, therefore, not applicable to sales returns and allowances and similar items."

Taxpayer interprets § 1.1341-1(f)(1) of the regulations to mean that section 1341(b)(2) is limited to sales returns and allowances and similar items and therefore does not disallow it from claiming section 1341 treatment with respect to the sales proceeds of the infringing products.

The plain language of the statute and the regulations does not support Taxpayer's conclusion. The statutory language of section 1341(b)(2) is very broad and in no way limits the application of the inventory exception to sales returns and allowances and similar items. Further, we interpret the first sentence of § 1.1341-1(f)(1) as equally broad. The second sentence of the regulation merely provides examples of the inventory exception and does not constitute the entire rule. Thus, even if the patent infringement damages otherwise met the requirements of section 1341(a), the application of section 1341 to the taxpayer's patent infringement damages payment would be disallowed under the section 1341(b)(2) inventory exception because the profits from the infringing products were included in the gross income of Taxpayer by reason of the sale or other disposition of stock in trade or property held by Taxpayer primarily for sale to customers in the ordinary course of Taxpayer's business.

CONCLUSION

Taxpayer is not eligible for the benefits of section 1341 for the payment of patent infringement damages because Taxpayer is not entitled to a deduction with respect to that payment. Even if Taxpayer were not otherwise precluded from using section 1341, the section 1341(b)(2) inventory exception would prohibit its use for Taxpayer's patent infringement damages.

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