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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER, ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
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SUBJECT:

Field Service Advice
Deduction of Copyright Infringement Litigation Costs

This Field Service Advice responds to your request dated December 14, 1998. It is not binding on Examination or Appeals and is not a final case determination. This document may not be cited as precedent.

LEGEND:

Taxpayer	=
Corp. A	=
Corp. B	=
X	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=

ISSUE:

Whether costs incurred in the pursuit and settlement of a copyright infringement action instituted by Taxpayer may be deducted as ordinary and necessary trade or business expenses or, instead, must be capitalized.

CONCLUSION:

To the extent that the litigation costs relate to the recovery of lost income, these should be deductible when accrued by Taxpayer; however, to the extent the costs are associated with a contest regarding Taxpayer's property interest itself these costs may be capital.

FACTS:

In Year 1, Taxpayer and Corp. A entered into a certain product licensing agreement (the Year 1 Agreement) whereby Corp. A would endeavor to develop certain products for use by customers in conjunction with Taxpayer's products. To that end, Taxpayer loaned various technological products to Corp. A with the express provision that title thereto would be retained by Taxpayer. This Year 1 agreement was terminated in Year 2; and eventually replaced in Year 3 with a new agreement (the Year 3 Agreement).

In the Year 3 Agreement, Corp. A acknowledged certain . Under that same Year 3 Agreement, Taxpayer granted Corp. A

The Year 3 agreement, nevertheless, did not end the dispute between Taxpayer and Corp. A.

In Year 5, Taxpayer filed a federal district court action against Corp. A and Corp. B claiming copyright infringement.

. Taxpayer asserted the infringement of X registered copyrights in all. Taxpayer also charged Corp. A with facilitating the infringement by Corp. B as well as direct infringement by Corp. A's own products. Taxpayer sought damages under the applicable copyright statutes and injunctive relief, including the destruction of all infringing products held by the defendants.

The defendants' answers included the factual assertion that the and the legal defenses of , and certain copyright defenses (including functionality, lack of originality, lack of similarity, and others). Neither defendant challenged the title or ownership, per se, of the copyrights which Taxpayer had relied upon in its action. Corp. A's answer conceded that Taxpayer had received the certificates of registration for the works in suit. Indeed, the district court noted that "the parties do not dispute [Taxpayer's] ownership of valid copyrights."

After several years of pretrial motions and rulings, summary judgment was granted in favor of defendants.

Taxpayer claimed deductions in connection with the suit for legal expenses it incurred during the Year 4 through Year 6 taxable years and for certain settlement payments made in the Year 7 taxable year. Examination disallowed all said deductions, finding these to be capital expenditures. The expenses for Year 4 and Year 5, however, were conceded by Appeals. The Year 6 through Year 7 taxable years have not been resolved and are currently in Appeals' jurisdiction.

LAW AND ANALYSIS:

Section 162 provides that a deduction from income shall be allowed for all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business. Section 263 provides that no deduction is allowed for capital expenditures. The provisions of section 263 take precedence over the business expense deduction of section 162. See section 161. Thus, the "norm" is capitalization. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992).

In determining whether litigation expenses are deductible, the origin and character of the claim with respect to which an expense was incurred is the controlling test. United States v. Gilmore, 372 U.S. 39 (1963). Gilmore dealt with the expenses of a divorce proceeding to defend against claims of community property ownership of certain closely-held corporate stock. The Supreme Court held those proceedings and the costs thereof "stemmed entirely from the marital relationship." Id. at 51. Because the costs were personal, they were also nondeductible. The origin of the claim test has also been adopted to determine whether litigation costs conceded to have been made in a trade or business

context are either currently deductible ordinary expenses or capital expenditures. To be currently deductible, the legal expenses may not have their origin in the acquisition or disposition of a capital asset. See Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970). A corollary to that principle regarding asset acquisition/disposition is that "the cost of defending or perfecting title to property" is inherently a capital expenditure. Treas. Reg. § 1.263-2(a). See also California & Hawaiian Sugar Refining Co. v. United States, 311 F.2d 235 (Ct. Cl. 1962). As discussed below, however, the precise nature of the "property" itself must still be recognized and distinguished from other property rights.

Intangible intellectual property right grants in the United States chiefly take the form of patent, trademark, or copyright. Despite the long history and increasingly commonplace nature of legal actions involving such rights, the tax treatment of the costs incurred therein as yet remains less than routine. This is true as a matter of Service position as well as judicial precedent. While, from a federal income tax vantage, viewing all such intellectual property litigation generically certainly has the unarguable appeal of expediency, such treatment also ignores the actual inherent differences and purposes of the various rights and remedies involved.

Those differences, inter alia, include: the life of such property grants, the rationales and business reasons for asserting such property rights (and against which entities), the industry context, the appropriate legal and factual defenses to any claimed infringement, whether the taxpayer is the plaintiff or defendant in the action in issue, and the ultimate result of the underlying litigation and/or settlement. Thus, although analogies among the various precedents that have delved into this area may be of some help, the factual circumstances and particular intangible property rights involved in the underlying litigation must still be critically examined in each case separately. See Rev. Rul. 78-389, 1978-2 C.B. 126. With those distinguishing considerations kept in mind, we should then look to the specific cases applying the general principles set out above.

The trademark and tradename cases, specifically, are probably the better settled of this group; however, those cases are of peculiar pedigree. It has been expressly held that legal fees incurred in a trademark infringement action are not deductible as ordinary and necessary expenses. Medco Products Co., Inc. v. Commissioner, 523 F.2d 137 (10th Cir. 1975), aff'g 62 T.C. 509 (1974). The Tenth Circuit in Medco relied in part upon Danskin, Inc. v. Commissioner, 331 F.2d 360 (2d Cir. 1964), aff'g 40 T.C. 318 (1963). Danskin held that costs to prevent trademark infringement "resemble the cost of perfecting or preserving title to property, a cost well established as a capital expenditure." Id. at 361. See also

Rust-Oleum Corp. v. Commissioner, 280 F.Supp. 796 (N.D. Ill. 1967) (parsing the underlying causes and the ultimate determination and settlement reached with regard to each of those counts, the opinion indicates that--although legal expenses for securing a judicial determination in rights to a specific trademark were chargeable to capital expenditure--the legal expenses for recovering lost profits as a result of infringement of a trademark by another should be currently deductible as ordinary and necessary business expenses; the court found that the taxpayer's motivation--and so too its costs--should be equally divided between capital and current expenses). Compare J.R. Wood & Sons, Inc. v. Commissioner, T.C. Memo. 1962-189, where the cost of an unsuccessful trademark infringement action was held entirely deductible.[1]

Notwithstanding Wood, another likely explanation of the more uniform treatment of costs in the trademark cases is that the trademark cases involved former section 177 (and the regulations thereunder) of the 1954 Code, which by their own terms only applied to trademark and tradename–not to patents and copyrights. Former section 177, repealed in 1986, provided that capital trademark expenditures could be amortized over five years. Those expenditures included the costs of protection and defense of trademarks. The regulations specifically stated that the section applied to "litigation expenses connected with infringement proceedings." Treas. Reg. § 1.177-1(b)(1). No analogous provision existed for patent and copyright litigation expenditures. On balance, regardless of the underpinning of their rationales, the trademark cases should not be offered as especially apposite authority for the capitalization of litigation costs in the copyright (or patent) context.

A more apt–if still inexact–comparison does exist between patents and copyrights. Patents and copyrights are intended to grant their author or inventor "the exclusive right" to their work for a limited time so as to "promote the progress of science and useful arts." U.S. Constitution, Art. I, § 8, cl. 8. Regarding patents, while it is unquestionably a property right having some value, note that simply because the United States Patent and Trademark Office (PTO) has issued the patent does not foreclose a subsequent challenge to that patent monopoly by another party in court. One reason for this is that the examination of patent claims and the granting thereof remains essentially an ex parte process. In litigating a patent infringement action, therefore, recognize that the first defense

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[1] Wood was expressly questioned in G.C.M. 38490 (Aug. 27, 1980), at 3, and its result was rejected. The G.C.M. asserts that protection of the trademarks involved in Wood was distinguishable from the patent litigation costs that the G.C.M. was addressing because the Wood costs were not "integrally related to the taxpayer[s'] business[es] and preservation of income[.]" Id. at 3.

of the alleged infringer is almost invariably that no valid patent exists. In other words, the purported patent should never have issued from the PTO. It is up to the plaintiff patent-holder to rebut that assertion. In essence, while sometimes going so far as to admit using the invention (method or device) described in the patent (i.e., the purported infringement), the defendant will still almost always argue that the patent should never have issued from the PTO in the first place. That there can be no infringement of an invalid patent is an inviolable tenet of patent law. See, e.g., Popeil Bros., Inc. v. Schick Electric, Inc., 494 F.2d 162 (7th Cir. 1974), aff'g 356 F.Supp. 240 (N.D. Ill. 1972). Whether the necessary litigation of the patent's validity is in essence tantamount to defending or perfecting its "title" to the grant of patent monopoly is open to debate. Although the patent itself is prima facie evidence of the invention, the federal courts can and do hold patents invalid with regularity.[2] Id.

In certain circumstances presented to the Service, the adverse opinion in Urquhart v. Commissioner, 215 F.2d 17 (3d Cir. 1954), rev'g 20 T.C. 944 (1953), has been cited as authority for the deductibility of patent litigation expenses by the patent holder. See G.C.M. 38490, at 4; PLR 8831001; PLR 8022002. The taxpayer in Urquhart was found to be in the specific trade or business of securing and exploiting patent rights through licensing thereof. The taxpayer was regularly incurring legal fees to protect everyday business revenue; nevertheless, the Commissioner sought capitalization treatment arguing that the infringement action was just an attack on the validity of the patent. The Tax Court agreed. Id. at 947-48. After the Third Circuit reversed, however, there has been no further challenge of the Urquhart holding. Thus, an acceptance by the Service of Urquhart has developed.

This tacit acceptance of Urquhart lends support to the notion that patent litigation expenses are presumed deductible as an initial premise. The seeming inconsistency with the "norm of capitalization" in this regard, however, is not so readily explained away. See INDOPCO, supra. Yet, presumably, a uniformly recognized "title" case would involve a dispute over an uncontestedly "valid" patent or patents between two or more claimants. See, e.g., Safety Tube Corp. v. Commissioner, 168 F.2d 787 (6th Cir. 1948) (the "gist of the controversy is the right to the asset which produced the income" held capital); Falls v. Commissioner, 7 T.C. 66 (1946), acq. 1946-2 C.B. 2 (legal fees in defense of action to compel assignment of patent must be capitalized in part and may be deducted in part); Heinemann v. Commissioner, T.C. Memo. 1988-164 (costs of

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[2] Patent invalidity can rest on numerous legal grounds. Those include: lack of novelty; anticipation/obviousness from the prior art; prior public use; and abandonment by the inventor, among others. 35 U.S.C. §§ 102, 103.

attempting to set aside assignment of patent to the Government by U.S. Army scientist were capital).

Notwithstanding the backdrop of the foregoing, your request seeks advice on the treatment of copyright litigation expenses–not trademark or patent.[3] In this respect, we are thus facing a much easier determination. The general principle of looking to the origin and character of the claim still applies, Gilmore, supra, as does the proscription of Treas. Reg. § 1.263-2(c) against deducting the costs of defending and perfecting title to property; but, in this case, there is no need to address questions surrounding the "nature of taxpayer's business" or the sundry attempted explanations of the varying tax treatments of the patent cases.

The issue of origin and character of the claim is essentially a factual determination. Rafter v. Commissioner, 60 T.C. 1, 8 (1973), aff'd, 489 F.2d 752 (2d Cir. 1974). On the basis of what we have been told of the underlying litigation, this case is akin to the example used in the section 212 regulations, i.e., "[a]ttorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the service rendered in collecting such rents." Treas. Reg. § 1.212-1(k).

This result is consistent with what we view as the better rule of Saltzman v. Commissioner, T.C. Memo. 1994-641. In Saltzman, a case you have also noted, in order to decide whether litigation costs were capital or ordinary under the origin of the claim rule, the court said it must "consider the issues involved, the nature and objectives of the litigation, the defenses asserted, the purposes for which the amounts claimed to be deductible were expended, the background of the litigation, and all facts pertaining to the controversy." Id. [68 T.C.M. at 1569, cites omitted, emphasis added]. See also Boagni v. Commissioner, 59 T.C. 708, 713 (1973). When litigation is conducted both to defend or perfect title (capital) and to preserve or collect income (deductible), the court may make an allocation of the costs between the two categories. Id. To the extent that the litigation costs relate to the recovery of lost income, these should be deductible when accrued by

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[3] In another context, the Service has ruled that since the property rights inherent in patents are similar to that of copyrights, the two should be treated similarly. See Rev. Rul. 75-202, 1975-1 C.B. 170; Rev. Rul. 60-226, 1960-1 C.B. 26 (whether certain royalty arrangements should be treated as sales). Nevertheless, the real differences between the two property rights should not be ignored for our purposes. For example, whereas a patent is issued for 17 years, a copyright (for post-1977 works) is in force for the life of the author plus 50 years or, in the case of a hired creator, 75 years from first publication. Similarly, the legal defenses and measures of damages in respective infringement actions are not simply coextensive.

Taxpayer; however, to the extent the costs are associated with a contest regarding Taxpayer's property interest itself, the costs may be capital under Saltzman.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

Given the above analysis and our conclusion, any litigating hazards for the Service here would stem from asserting that the "injunctive relief" portion of the underlying infringement suit constituted a capital expenditure by nature. If a court was unwilling to accept that title was not directly challenged in Taxpayer's infringement action, it may be unwilling to use Saltzman to justify any allocation of the litigation costs between deductible and capital expenses. Thus, it would find all expenses deductible.

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