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MEMORANDUM FOR

FROM: William A. Jackson
Chief, Branch 5
Income Tax and Accounting

SUBJECT: Supplemental issues related to TAM-115287-01

This Chief Counsel Service Advice responds to your request for additional guidance regarding issues raised by the Taxpayer related to our previous technical advice memorandum TAM-115287-01 (TAM 200310001).

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LEGEND:

Taxpayer =

District Court =

Patent Holder =

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.

CONCLUSION

Taxpayer is not 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 amounting to sales in excess of Amount $1. In Year 8, Patent Holder filed a patent infringement lawsuit in District Court. In its lawsuit against Taxpayer, Patent Holder alleged that Taxpayer's manufacture and sale of the Units infringed certain patents of Patent Holder 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 Patent Holder's patents. On appeal, the District Court's ruling was reversed. Ultimately Taxpayer was ordered to pay Patent Holder the sum of Amount $2 constituting damages and pre-judgment interest in the respective amounts of Amount $3 and Amount $4. . In the fiscal year ending Month 1 Year 20 (FYE Year 20), Taxpayer paid the amount awarded to Patent Holder. Taxpayer claims that the damages paid to Patent Holder 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.

In the "FACTS" section of Taxpayer's Summary of Position Concerning Applicability of Section 1341 to Patent Infringement Costs (Taxpayer's Summary), Taxpayer states as follows: "The assigned by the court to assist in computing the infringement damages required a portion of profits earned by [Taxpayer] to be disgorged to [Patent Holder]." Further on in the Law and Analysis section of Taxpayer's Summary, Taxpayer disputes the TAM's description of the patent infringement damages as analogous to a royalty paid by Taxpayer to Patent Holder. However, this statement in the TAM comes directly from the joint statement of facts included in the original request for technical advice agreed to by both Taxpayer and the field. This joint statement of facts clearly states that Taxpayer claims that the damages paid to Patent Holder were based upon a reasonable royalty. While the TAM was being considered in the National Office, Taxpayer never provided any third-party substantiation or court files to support the factual premise Taxpayer now is asserting in Taxpayer's Summary, which is that the damages paid were a disgorgement of profits earned by Taxpayer. We are not aware of any such information being provided by Taxpayer to date that would support this new assertion. Thus, based on the information provided to the National Office and agreed to by both Taxpayer and the field, we stand by the facts statement in the TAM that the patent infringement damages paid by Taxpayer are based upon a reasonable royalty. See also the discussion infra on section 263A.

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. Enactment and legislative history of 1342

Under former section 1342, if a taxpayer took a deduction for patent infringement damages paid in a prior year and later recovered the damages due to reversal of the court decision on the ground of fraud or undue influence, the taxpayer was allowed the option of either (1) including the recovered amount in gross income, or (2) excluding the recovered damages from the taxpayer's gross income and adding to the tax of the recovery year an amount equal to the difference between the tax paid in the prior year of deduction and the tax that would have been paid had the deduction not been taken. If the tax so computed is less than the tax which would be paid by including the recovery in gross income, that is the amount of tax to be paid for the recovery year.[1]

Section 1342 applied with respect to taxable years ending after the enactment date of August 11, 1955. This section was repealed in 1976. See the section 1901(a)(147) of the Taxpayer Relief Act of 1976, Pub. Law 94-455.

In its original submission and its recent rebuttal to the TAM, Taxpayer claims that the enactment of section 1342 shows that Congress intended patent infringement payments to qualify for section 1341 relief. Taxpayer points to the fact that section 1341 and 1342 use the same terminology and to the legislative history accompanying section 1342 in support of its assertion.

First, we agree with your statement included in your original TAM submission that legislative intent behind section 1342 may not be used to interpret section 1341, particularly in light of the fact that section 1342 was enacted subsequently and by a different Congress. Generally, subsequent statutes may not be used to interpret earlier

[1] Former section 1342 expressly provided that if an item was deducted from gross income for a prior taxable year because it appeared that another person held an unrestricted right to such item as a result of a court decision in a patent infringement suit, and gross income is increased for the taxable year because it was established after the close of such prior taxable year that such other person did not have an unrestricted right to such item because of the subsequent reversal of such court decision on the ground that the court decision was induced by fraud or undue influence, and the amount of the increase in gross income exceeds $3,000, then the tax for the taxable year shall be the lesser of the tax for the taxable year computed with the gross income so increased; or an amount equal to the tax for the taxable year computed without such increase in gross income, plus the increase in tax (including interest) which would result solely from the elimination os such item as a deduction from gross income for such prior taxable year.

laws. Penn. Mut. Life. Ins. Co. v. Lederer, 252 U.S. 523, 537 (1920); United States v. Southwestern Cable Co., 392 U.S. 157, 170 (1968). Nor is there any suggestion in the language of section 1342 that section 1341 applies to the payment of patent infringement damages. Section 1342 provides a method for computing tax on an amount received by a taxpayer in a very unique set of facts (e.g. the lower court decision must be reversed on the ground of fraud or undue influence). Section 1341, on the other hand, applies to certain payments by a taxpayer. In short, section 1342 on its face provides no support for Taxpayer's position.

Second, the legislative history accompanying the enactment of section 1342 does not support the Taxpayer's position. The Senate Committee report describes section 1342 as "similar" and "complementary" to section 1341.[2] S. Rep. No. 1254, 84th Cong., 1st Sess. 2 (1955). Taxpayer argues that the legislative history surrounding the enactment of section 1342 makes it clear that in providing this new relief, Congress assumed similar relief was already available to the infringing taxpayers under section 1341. But, the committee report language cited by Taxpayer is merely an acknowledgment that some of the same terms and similar framework of section 1341 was used to construct an exception for the limited number of taxpayers falling under the provisions of section 1342. Both sections 1341 and 1342 were "similar" and complimentary" because they each created a particular exception to the annual system of accounting. This legislative history does not state, nor does it suggest, that section 1341 is intended to apply to the payor of patent infringement damages. Thus, we reject Taxpayer's argument that section 1342 and its legislative history provides support for Taxpayer's position.

2. Section 263A

In our previous technical advice memorandum (TAM), we concluded that Taxpayer was required to include certain payments for patent infringement damages in its inventory costs pursuant to section 263A. Taxpayer disputes this conclusion. As explained in detail below, the arguments presented by Taxpayer related to the application of section 263A to patent infringement damages are unpersuasive, unsupported, or incorrect. Our prior TAM correctly concludes that the patent infringement damages at issues are

[2] "Section 1341 deals with the situation where a taxpayer mistakenly includes an item in his gross income of a prior year(s), and in a later year is required to restore the money or property which gave rise to the item of income in the prior year. Where the restored items amounts to $3,000 or more, section 1341 allows the taxpayer the option of: First, deducting the restored amount in the tax year it is restored to a third party; or second, computing the tax for the restoration year without deducting the amount restored, and then lowering the tax or the taxable-restoration-year by the amount of decrease in tax caused by excluding the restored item(s) from the income of the earlier year(s) in which reported. The Senate amendment simply extends a similar option to a taxpayer who, mistakenly believing that a third party had a claim of right to money on property, takes a deduction for the item or items in an earlier year or years." 101 Part 10 Congressional Record, page 12705- 12706 (August 1, 1955) (Jenkins). "This amendment adds a new section to the 1954 code intended to be complementary to section 1341 of that code." Id. at 12705 (Cooper).

includible in inventory costs under section 263A because they are incurred by reason of an inventory production activity.

Taxpayer contends that U.S. v. Skelly Oil Co., 394 U.S. 678 (1968), "makes it clear that in the context of section 1341 it is irrelevant whether the deduction represents [a] loss or business expense or for that matter a deduction in cost of goods sold, as long as it would represent a valid offset against income." The Skelly Oil opinion, however, does not actually say that. The parties disagreed over whether a deduction for the refunds at issue in the case was allowed under section 162 or section 165. The opinion states that whether the deduction at issue was allowed under section 162 or section 165 was irrelevant so long as a deduction was allowed. The Supreme Court's opinion does not mention, or make any implications with regard to, "cost of goods sold" or "valid offsets against income." Skelly Oil does not support Taxpayer's position.

Second, Taxpayer cites a group of "authorities" – Burnham Corp. v. Comm., 878 F.2d. 86 (2nd Cir. 1989); Becker Bros. v. U.S., 7 F.2d. 3 (2nd Cir. 1925); PLR 9310015 (1993); Treas. Reg. 111 section 29.43-2 (1939); Treas. Reg. section 1.461-1(a)(3)(ii) (1954) – intended to support its contention that patent infringement damages are deductible business expenses under section 162 rather than inventory costs under section 263A. As explained below, however, the cited "authorities" either do not address the section 162 versus section 263A issue or involved taxable years prior to the effective date of section 263A. Thus, the "authorities" do not support Taxpayer's position.

At issue on appeal in Burnham was whether that taxpayer had satisfied the "all-events test" in 1980 so that it was entitled to a current deduction for patent infringement damages it agreed to pay beginning in 1980. Burnham Corp. was a manufacturer of heating and cooling equipment, but the Burnham opinion does not address the applicability of section 263A because section 263A was not applicable to the years at issue in the case.

In Becker Bros., the question of whether the damages were properly characterized as an inventory cost was not at issue; the case involved the question of whether the taxpayer could deduct losses that arose from an illegal transaction. Moreover, Becker Bros. was decided well before the enactment of section 263A.

In PLR 9310015, a taxpayer engaged in manufacturing equipment was sued for infringing the patent of another corporation. At the time the taxpayer filed its ruling request, it was appealing an adverse decision by the trial court. That PLR concludes that

> [a]ny amount allowable as a deduction under Chapter 1 of the Code with respect to Taxpayer's payment of either the court-awarded judgment entered against Taxpayer . . . or a negotiated settlement of that judgment . . . will constitute a deduction with respect to a liability that arises out of a tort

> within the meaning of section 172(f)(1)(B), and, to the extent it is an amount taken into account in computing a NOL for the year of the deduction is eligible for the ten-year carryback as provided in section 172(b)(1)(C) . . . .
>
> This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Taxpayer's reliance on PLR 9310015 is misplaced. The applicability of section 263A to patent infringement damages was not considered or discussed in the PLR. Indeed, the PLR expressly provides that its conclusion applies only if the infringement damages or settlement payments are allowed as a deduction under Chapter 1 of the Code. The conclusion of the PLR is inapplicable to the extent that those costs are includible in inventory costs. In addition, the PLR as well as section 6110(j)(3) specifically provide that the PLR may not be used or cited as precedent.

The 1939 and 1954 regulations cited by Taxpayer do not support the proposition that patent infringement damages incurred by reason of an inventory production activity are deductions rather than inventory costs. Those regulations do not consider the applicability of section 263A because they pre-date the effective date of section 263A. Moreover, the 1954 regulations cited address the proper time for deducting a liability where the liability is disputed, assuming that a deduction is otherwise allowable. Section 1.461-1(a)(3)(ii) (1954) provides

> Where there is a dispute and the entire liability is contested, judgments on account of patent infringement, personal injuries or other causes, or other binding adjudications, including decisions of referees and boards of review under workmen's compensation laws, are deductions from gross income when the claim is finally adjudicated or is paid, depending upon the taxpayer's method of accounting.

This does not provide authority for allowing a deduction for costs properly included in inventory costs. The regulations assume that the costs are otherwise deductible. Obviously, if an individual is found liable for a personal injury to another and there is no statutory provision that allows the individual a deduction for the damages, the individual is not entitled to deduct the damage award by virtue of these 1954 regulations. These regulations simply clarify that the all-events test is not satisfied until the claim is finally adjudicated and that a taxpayer using the cash receipts and disbursements method may not deduct a disputed claim until it is paid.

Third, Taxpayer argues that the TAM characterizes the patent infringement damages as royalties and that that characterization is factually incorrect. Along these same lines, Taxpayer argues that our reliance on Plastic Engineering Co. v. Commissioner, T.C. Memo. 2001-324, is misplaced because that case involved royalties for future use of a patent[3] rather than patent infringement damages attributable to past production of property.

These arguments are based on a misinterpretation of the TAM. We did not conclude that the patent infringement payments were royalties. We concluded that they were indirect costs incurred by reason of an inventory production activity and analogous to royalties. Patent infringement damages are essentially payment for the use of an asset, i.e., a patent. As such, they are similar to royalty expenses, which must be included in inventory costs if incurred in connection with a production activity. Irrespective of how the infringement damages were computed, Taxpayer was required to pay Patent Holder for retroactive and continued use of its patent without obtaining its permission. Had Taxpayer obtained permission prior to using the patent, the costs of using the patent would be indirect costs includible in inventory costs under section 263A. That Taxpayer was found liable for these payments by a court does not change the fact that they were incurred by reason of a production activity.

Fourth, Taxpayer asserts that our conclusion that patent infringement damages are includible in inventory costs is erroneous because such inclusion is inconsistent with the matching principles underlying section 263A. In effect, Taxpayer argues that section 263A is inapplicable to indirect costs to the extent inclusion of those costs in inventory would not result in what Taxpayer considers a proper matching of income and expense. Neither the statute nor the regulations contain an exception to capitalization in circumstances where capitalization would not yield a satisfactory matching of income and expense. Section 263A and the regulations thereunder produce a better matching of income and expense than was required under prior law, but those provisions may not produce a perfect matching of income and expense in all cases. The regulations provide that direct and indirect costs properly allocable to inventory produced by the taxpayer must be included in inventory costs. See section 1.263A-1(e)(1). Indirect costs are properly allocable to property produced when the costs are incurred by reason of the performance of a production activity. See section 1.263A-1(e)(3) (emphasis added). The nature of a cost, in terms of whether it is an indirect cost because incurred by reason of the performance of a production activity, does not change simply because the production activity was completed before the cost was incurred for federal income tax purposes.

[3]Contrary to Taxpayer's assertion, Plastic Engineering involved royalty liabilities arising from contemporaneous, not future, use of a patent. T.C. Memo. 2001-324.

Finally, Taxpayer asserts that patent infringement damages are deductible as losses under section 165 and that section 165 losses are not required to be capitalized under section 263A. Section 1.263A-1(e)(3)(iii)(D) does, in fact, provide that losses deductible under section 165 are indirect costs that are not required to be capitalized under section 263A. However, in the TAM we determined that the patent infringement damages in this case are ordinary business expenses that are deductible under section 162 rather than losses under section 165. Taxpayer, in its Summary, provided no additional support for its assertion that the damages are deductible under section 165. Therefore, based on our prior determination we maintain that section 1.263A-1(e)(3)(iii)(D) is inapplicable here.

In conclusion, Taxpayer was held liable for damages for infringing a patent. Absent the applicability of section 263A and the regulations thereunder, patent infringement damages are deductible business expenses under section 162. Section 263A requires inclusion in inventory costs of otherwise deductible expenditures that are incurred by reason of a production activity. Had Taxpayer entered into a proper, contractual agreement for use of the patent, the expenses incurred by Taxpayer for the use the patent would have been capitalized to inventory produced using the patent in the year that the inventory was produced. Plastic Engineering, supra. The patent infringement damages are characterized based on the activity which resulted in the liability – the use of a patent in the production of Taxpayer's inventory. These costs would have been includible in inventory costs if incurred at the time of production, and remain inventory costs even though incurred in subsequent taxable years.

3. Inventory exception

We maintain the position in the TAM that even if Taxpayer's payment of the patent infringement damages to Patent Holder met all of the requirements of section 1341(a), Taxpayer would still not be entitled to relief under section 1341 because of 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 the taxpayer's trade or business.

Section 1.1341-1(f) of the regulations states that the provisions of section 1341 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 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 section 1.1341-1(f) narrowly and believes that the exception only applies to "sales returns and allowances and similar items." It asserts that because its alleged deduction for the patent infringement payment was not a sales return, allowance or similar item, the exception is inapplicable.

Taxpayer argues that the legislative history of section 462 and Killeen v. United States, 63-1 USTC (CCH) P9351 (S.D.Cal. 1962), supports its assertion. Each of Taxpayer's arguments is addressed separately below.

(A) Plain language of the statute and the regulations

As discussed in the TAM, we believe that the plain language of section 1341(b)(2) is clear; therefore, analysis of the legislative history behind this statutory provision is unnecessary.[4] In addition, the plain meaning of the regulations does not support the taxpayer's conclusion that the section 1341(b)(2) exception is limited to sales returns and allowance and similar items. As the plain meaning of the regulatory provision indicates, the second sentence merely provides examples of the inventory exception and does not constitute the entire rule.

(B) Legislative history

I. Legislative history of section 1341(b)(2)

Even if the plain language of section 1341(b)(2) demanded an analysis of its legislative history, the legislative history does not support Taxpayer's assertion.

The legislative history behind section 1341(b)(2) does not state that the section 1341 (b)(2) exception is limited to "sales returns and allowances and similar items." The committee reports state that section 1341 "is inapplicable to refunds, allowances, bad debts, etc., pertaining to sales of inventory or stock in trade which may be provided for under section 462 relating to reserves." S. Rep. No. 1622, 83rd Cong., 2d Sess., 188 (1954). See also H. Rep. 1839, 2d Sess., A294. This language, particularly the words "etc" and "pertaining to", is not restrictive, but suggestive and illustrative. In fact, the

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4 Interpretation of a statute must begin with the statute's language. See United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 241 (1989); Landreth Timber Co. v. Landreth, 471 U.S. 681, 685 (1985). If the plain meaning of the statutory text is clear, recourse to the legislative history is unnecessary. Darby v. Cisneros, 509 U.S. 137, 147 (1993); INS v. Phinpathya, 464 U.S. 183, 189 (1984) ("This Court has noted on numerous occasions that in all cases involving statutory construction, our starting point must be the language employed by Congress, . . . and we assume that the legislative purpose is expressed by the ordinary meaning of the words used).

legislative history indicates that Congress intended to keep the scope of section 1341(b)(2) somewhat undetermined. In the Hearings before the Committee on Finance United States Senate 83rd Congress, 2d Session, Part 2, 1049 (1954), it states "although the wording is not clear, it would appear that sales of electric energy and gas may fall within the scope of the exception provisions of subsection (b)(2) of section 1341."

II. Former section 462

Similarly, the legislative history behind section 462 also does not suggest that the section 1341(b)(2) exception is restricted to sales returns and allowances and similar items. In 1954, Congress enacted both sections 462 and 1341. Section 462 allowed an accrual method taxpayer to take a deduction for certain expenses estimated to be incurred in the succeeding tax year.

Approximately one year after its enactment, section 462 was repealed retroactively. Committee reports at the time of the repeal clearly indicate that the repeal was necessary due to a substantial underestimation in the loss of revenue. The repeal did not intend "to disturb prior law" and relied on Treasury assurances "that the repeal of [section 462] should operate simply to reestablish the law which would have been applicable if [section 462] had never been enacted." H. Rep. No. 293, 84th Cong., 1st Sess, 1955-2 C.B. 852, 854-5; S. Rep No. 372, 84th Cong., 1st Sess.; at 1955-2 C.B. 858, 859-861. Consequently, we believe that the legislative history of section 462 is not the proper source from which to draw inferences regarding the present state of the law.

Taxpayer asserts that the inventory exception of section 1341(b)(2) was designed to prevent a taxpayer from claiming both a deduction under former section 462 as well as the benefit under section 1341(a) for the same item. However, section 462 was repealed shortly after enactment and section 1341 was not repealed or amended contemporaneously with section 462's repeal. If the sole purpose for the section 1341(b)(2) exception was to disallow section 1341 relief for an item covered by section 462, section 1341(b)(2) would have been repealed contemporaneously with section 462. The fact that section 1341(b)(2) remains effective suggests that Congress intended the exception to encompass more than "sale returns and allowances and similar items" for which a deduction is allowed under section 462

(C) An unpublished memorandum

In its Taxpayer Summary, Taxpayer makes reference to "an unpublished technical advice memorandum provided by the IRS National Office to the Joint Committee". We are not aware of such a technical advice memorandum. Further, we are not aware of procedures for the issuance of a technical advice memorandum to the Joint Committee. Taxpayer may be referring to an unpublished internal IRS memorandum issued by the Corporate Tax Division to the Appeals Division. This internal memorandum does suggest a narrow interpretation of the scope of section 1341(b)(2).

The memorandum is inconsistent with IRS Office of Chief Counsel's current interpretation of section 1341(b)(2). See TAM 200050005 and FSA 200036011. We believe that the memorandum's conclusions pertaining to section 1341(b)(2) are incorrect and that this unpublished memorandum does not provide any precedential value from which to draw inferences regarding the correct application of the law to Taxpayer's case. See section 6110(k)(3) of the Code.

(D) Killeen v. United States

Taxpayer suggests that its case is comparable to the case of Killeen v. United States, 63-1 USTC (CCH) P9351 (S.D. Cal. 1962), an unreported case. In Killeen, the taxpayer entered into an agreement with Sachs in which Killeen agreed to manufacture and sell a device and Sachs agreed to design and market the device. This joint venture agreement provided that the net profits would be divided equally between the two parties. Sachs later obtained a judgment in state court that Killeen had wrongfully withheld a portion of the profits. Killeen satisfied the judgment by paying the disputed amount to Sachs and then claimed a refund under section 1341. The district court held that the profits paid in satisfaction of the state court judgment had been included as an item of the taxpayer's gross income.[5] The district court also held as a finding of fact that the item was not included in Killeen's gross income by reason of the sale or other disposition of stock in trade of the taxpayer or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Instead the district court held that the item was included in gross income because Killeen had wrongfully withheld the portion of profits in violation of the joint venture agreement.

We agree with your statement included in your original TAM submission that Killeen is factually distinguishable from the present case. Unlike the present case, Killeen involved

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5 In Killeen, there was no question that the amounts paid in satisfaction of the judgment were profits because the parties stipulated in their pretrial conference order that the satisfaction of judgment by the transfer of money and property in kind constituted a restoration within the meaning of and subject to section 1341.

an income splitting arrangement in which one party failed to pay over the correct share of profits to the other party. We believe that the case is distinguishable because the deduction for the damages arose from a claim for a share of the profits pursuant to the joint venture agreement and not from a sale of infringing inventory.[6]

In summary, we continue to disagree with Taxpayer's position that the section 1341(b)(2) limitation only applies to sales returns and allowances and similar items. The plain language of section 1341(b)(2) and section 1.1341-1(f)(1) of the regulations does not support Taxpayer's interpretation. Because of the unambiguous meaning of the language of section 1341(b)(2), it is unnecessary to refer to the legislative history underlying the statute. Even if the legislative history is examined, however, it does not provide clear support for Taxpayer's position that section 1341(b)(2) is limited to sales returns and allowances and similar items. Nor does it support Taxpayer's assertion that section 1341(b)(2) only precludes the availability of section 1341 relief to an item for which an estimated expense deduction is available under former section 462, a Code section that was retroactively repealed in 1955. Finally, Killeen v. United States does not support Taxpayer's position because it is factually distinguishable from Taxpayer's case.

4. Additional Arguments

Taxpayer's Summary sets out five statutory requirements that must be satisfied in order to qualify for relief under section 1341. The submission correctly points out that the TAM denies relief based on two of these requirements: (1) the absence of a deduction allowed when it is established that the taxpayer did not have a right to the item of gross income and is required to restore it, and (2) the application of the limitation of section 1341(b)(2), which denies section 1341 relief for inventory related items.

Implicit in Taxpayer's Summary is the suggestion that the National Office and Exam concede that Taxpayer meets the other requirements and have no other arguments upon which to deny section 1341 relief. This is not the case. In stating the two reasons for

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6 The court in Maier Brewing Co. v. Commissioner, T.C. Memo 1987-385**,** a case similar to the present case, made a similar distinction. Maier involved a 1958 sale of a corporation. The minority shareholder objected to the terms of the sale and obtained a rescission order in 1968. The sales price was repaid by the corporation ten years after the sale was completed and the taxpayer maintained that it was entitled to relief provided by section 1341 because a portion of the repayment represented profit during the ten years generated by the corporation's assets. The Ninth Circuit held that this portion of the repayment was not for a profit generated by the corporate assets but was akin to interest or rent because it was a payment made for the use of the corporation's assets. Bound by this determination, the tax court ruled that this portion of the repayment did not represent an item that the taxpayer had previously included in its gross income. Because the court determined that the taxpayer was not entitled to section 1341 treatment on this ground, the court did not address the applicability of section 1341(b)(2). However, the court noted in making its section 1341 determination that Killeen was factually distinguishable from the case at issue. The present case more closely resembles Maier because in both cases the damage payment was apparently made to compensate for the taxpayer's infringing use.

denial of relief in the TAM, the National Office did not intend to foreclose other arguments for denying relief. Because the failure to meet any one of the five requirements listed in Taxpayer's Summary results in the denial of section 1341 relief, it was not necessary for the TAM to discuss all reasons for denial. The fact that the TAM is silent on these other requirements should not suggest that Taxpayer has met these requirements.

, we provide the following additional arguments as reasons for denying section 1341 relief to Taxpayer's payment of patent infringement damages.

(A) An item included in gross income in a previous year

Section 1341(a)(1) of the Code states that the statute does not apply unless "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." We agree with your statement included in your original TAM submission that the income earned by Taxpayer when it sold infringing products was included in Taxpayer's gross income for section 1341 purposes.

Taxpayer received gross proceeds from the sale of the infringing goods. It paid damages in the form of royalties. These damages, as discussed above, are includible in COGS. We do not view COGS as a factor in determining whether an item was included in gross income under section 1341. Rather, we interpret "included in gross income" under section 1341 to mean included in the computation of gross income.

This view was applied in Rev. Rul. 72-28, 1972-1 C.B. 269. Rev. Rul. 72-28 essentially held that gross receipts is considered in determining whether an item was included in gross income under section 1341.[7] See GCM 35403, 1973 IRS GCM Lexis 177.[8]

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[7] In Rev. Rul. 72-28 a public utility company paid a rate on gas purchases and included the rate in charging its customers. The company included this rate in calculating its COGS and included the comparable amount it received from its customers in its gross receipts. Thus, in the same year, the company's gross receipts and COGS increased by the same amount, leaving gross income as defined under Treas. Reg. 1.61-3(a) unaffected. The ruling holds that the public utility company was eligible for section 1341 treatment, and the fact that the taxpayer had increased COGS in the prior year had "no relevancy in determining the application of section 1341."

[8] The G.C.M. states that this interpretation allows for consideration of items included in gross receipts, which are included in the computation of gross income under Treas. Reg. 1.61-3(a). If "included in gross income" were not so interpreted, the utility company would have been precluded from applying section 1341 to items received in prior years (and restored in later years) to the extent COGS was equal to or greater than gross receipts. Such a result may be viewed as contrary to section 1341(b)(2), which specifically allows a utility company to apply the statute.

Moreover, looking to gross receipts enables us to comply with the requirement of section 1341 that an "item" has been included in gross income under a claim of right. If we were instead to adopt the definition under Treas. Reg. 1.61-3(a), no "items" would remain after the calculation of gross income. On this issue, GCM 35403 stated: "all that would remain would be a net aggregate amount. In no case...would it be possible to

(B) Item included in gross income in a previous year under a claim of right because it appeared that the taxpayer had an unrestricted right to the item

Section 1341(a)(2) of the Code states that the statute applies if "a deduction is allowable for the taxable year because it was established after the close of the [taxable year in which an item was included in gross income] that the taxpayer did not have an unrestricted right to such item or to a portion of such item." Section 1.1341-1(a)(2) of the regulations clarifies that a deduction must be allowable because an item received and included in gross income in a prior year has been restored to another.

Taxpayer claims that the infringement payments it made to Patent Holder should be characterized as a restoration of a portion of the proceeds generated by the sale of the infringing goods. However, in its complaint filed with the District Court, Patent Holder sought an injunction and an "award of damages adequate to compensate for the infringement of its patents. . . ." No where in its complaint did Patent Holder seek to recover any part of the profits Taxpayer derived from the sales of the infringing goods. In its order, the Court awarded Patent Holder "damages pursuant to 35 U.S.C. 284 for infringement." Because the amount of damages pursuant to 35 U.S.C. 284 is based on the Patent Holder's lost profits and/or a reasonable royalty and the Service has no contrary evidence showing otherwise, we agree with your statement included in your original TAM submission that Taxpayer's payment of damages was not a restoration of sale proceeds to Patent Holder. See Maier Brewing Co. v. Commissioner, T.C. Memo. 1987-385, aff'd 916 F.2d 716 (9th Cir. 1990)(involving a taxpayer that purchased the assets of another company and as a result of the rescission of the sale paid damages to the seller, the Tax Court held that the buyer was not entitled to section 1341 treatment because the damages were equivalent to rent for the use of the seller's assets rather than a repayment of the buyer's profits). See also section 1.1341-1(a) and (h) of the regulations (payment of legal fees not an item previously included in payor's gross income).

Because Taxpayer was not required to pay to Patent Holder any of Taxpayer's proceeds derived from the sales of the infringing goods, Taxpayer's right to the sale proceeds remained unrestricted. In other words, its obligation to pay damages for patent infringement did not restrict Taxpayer's right to retain an item of gross income. Consequently, Taxpayer does not meet the terms of section 1341(a) because its payment of the patent infringement damages is not a restoration of an item included in its gross income because it appeared that the taxpayer had an unrestricted right to the item.

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identify an item of gross income....It must necessarily be possible to identify the various component items of gross income in order for section 1341 to have any vitality."

See Rep. No. 1622, 93d Cong., 2d Sess. 452 (1954) (stating "[i]f the right to the payment is absolute, the fact that a subsequent liability arises in a related transaction should not entitle the taxpayer to a special relief of section 1341. Thus, bad debt deductions are not entitled to section 1341 treatment because even though the debt is uncollectible, the taxpayer's right to payment is unrestricted.") See also Wallace v. United States, 309 F. Supp. 748 (S.D. Iowa 1970), aff'd, 439 F.2d 757 (8th Cir. 1971); cert. denied, 404 U.S. 831 (1971)(holding section 1341 inapplicable to dividends received by taxpayer and paid over to former wife pursuant to divorce decree because taxpayer had unrestricted right to the dividend income and merely used the dividend income to in order to satisfy his marital claims).

For all of the reasons stated above, we find that arguments asserted by Taxpayer in Taxpayer's Summary to be unpersuasive and we reaffirm our conclusion in the TAM that Taxpayer is not entitled to relief under section 1341(a) for the payment of patent infringement damages.

If you have any questions regarding this advice, please contact at 622-4960.