## Internal Revenue Service

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[Third Party Communication:

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To: CC:ITA:B03 PLR-109578-15

Date:

June 01, 2015

TY:

LEGEND:

Taxpayer =

Affiliate =

Technology =

\$A =

\$B =

Year X =

Year Y =

Year Z =

Dear :

This is in response to your letter dated February 24, 2015. In your letter, you requested that the IRS rule that the legal costs arising out of a patent infringement case that the taxpayer has incurred in Year Y and will incur in subsequent tax years are deductible as ordinary and necessary business expenses under section 162 of the Internal Revenue code. The request is based on section 162 of the Code.

## **FACTS**

Affiliate of Taxpayer owns a patent covering certain Technology. Taxpayer manufactures products based on the technical specifications and standards Affiliate

provides using Technology. Taxpayer entered into a license agreement with Affiliate that provides Taxpayer with the technical knowledge to manufacture products protected by Affiliate's patent. Taxpayer pays a royalty to Affiliate for use of the patent based on a percentage of sales revenue generated by the products covered by the patent. Taxpayer manufactures and sells these products in the United States.

Taxpayer claims that another company has manufactured products infringing Affiliate's patent. Taxpayer asserts that the company is selling these products in the United States in direct competition with Taxpayer. The license agreement between Taxpayer and Affiliate requires Taxpayer to notify Affiliate if Taxpayer receives any information about a third party violating the intellectual property owned by Affiliate. Under the agreement, Affiliate has sole control of the defense and any related settlement negotiations with the third party. Additionally, the agreement states that expenses incurred in defending the intellectual property are shared by both Taxpayer and Affiliate, based on the proportion of the economic benefit derived from sales of products covered by the intellectual property. If any settlement occurs where the Taxpayer or Affiliate receives funds from a third party, the proceeds are also shared in the same manner of allocation.

In Year X, Taxpayer filed a patent infringement claim against the company it believes is infringing Affiliate's patent. The company sought a declaratory judgment in federal court against the Taxpayer in Year X in which it claimed that it is not infringing upon Affiliate's patent and that the patent was not validly issued. None of the claims asserted that Affiliate did not have legal title to the patent. Taxpayer and Affiliate have incurred approximately \$A in legal costs in Year Y to litigate against the company infringing upon Affiliate's intellectual property, and have apportioned these costs in the allocation method described in the license agreement. Approximately \$B in legal costs are expected to be incurred in Year Z and they will continue to be incurred in subsequent tax years until the case is settled with the competing company.

## LAW AND ANALYSIS

Section 162(a) of the Code generally allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

Section 263(a) generally requires capitalization of amounts paid for permanent improvements or betterments made to increase the value of any property or estate.

Section 1.263(a)-4 of the regulations provides rules for applying § 263(a) to an amount paid to acquire or create intangibles.

Under § 1.263(a)-4(b)(1)(ii), a taxpayer must capitalize an amount paid to create an intangible described in § 1.263(a)-4(d).

Under §1.263(a)-4(d)(5)(i), a taxpayer must capitalize amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade its rights under a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.

Section 1.263(a)-4(d)(9)(i) requires a taxpayer to capitalize amounts paid to another party to defend or perfect title to intangible property if that other party challenges the taxpayer's title to the intangible property.

Taxpayer's litigation costs are ordinary and necessary under § 162(a) because they are incurred pursuant to a legal obligation under a license agreement related to Taxpayer's trade or business. The primary issue is whether they are deductible under the origin of the claim test established in <a href="United States v. Gilmore">United States v. Gilmore</a>, 372 U.S. 39 (1963). The test generally determines whether an amount incurred in litigation is currently deductible under § 162(a). See also <a href="Woodward v. Commissioner">Woodward v. Commissioner</a>, 397 U.S. 572 (1970); <a href="United States v. Hilton Hotels Corp.">United States v. Hilton Hotels Corp.</a>, 397 U.S. 580 (1970). In <a href="Gilmore">Gilmore</a>, the Court held that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense [is] 'business' or 'personal' and hence whether it is deductible or not...". <a href="Gilmore">Gilmore</a> at 49.

In applying the origin of the claim test, the taxpayer's purpose in undertaking or defending a particular piece of litigation is not relevant. See <u>Woodward</u> at 578. The origin of the claim test is an objective inquiry to determine the origin and character of the claim, taking into account all of the facts and circumstances; it is not a test dependent on the formal titles to pleadings or subjective motives. Thus, while legal fees paid by a business in connection with business-related litigation generally are deductible as ordinary and necessary expenses under § 162, litigation fees with their origin in a capital transaction are required to be capitalized under the origin of the claim test.

A taxpayer must capitalize amounts paid to another party to defend or perfect title to intangible property if that other party challenges the taxpayer's title to the intangible property. § 1.263(a)-4(d)(9)(i); Safety Tube Corp. v. Commissioner, 168 F.2d 787 (6<sup>th</sup> Cir. 1948) (legal fees required to be capitalized where controversy was over which party had title and ownership of the patent). This rule, however, is "not intended to require capitalization of amounts paid to protect property against infringement and to recover profits and damages as a result of an infringement, which are generally deductible as ordinary and necessary business expenses under § 162(a). See, e.g., Urquhart v. Commissioner, 215 F.2d 17 (3<sup>rd</sup> Cir. 1954) (expenditures made by a licensor of patents to protect against infringement and to recover profits and damages were made to protect, conserve, and maintain business profits, and not to defend or perfect title to property). Whether an amount is paid to defend or perfect title, on the one hand, or to protect against infringement, on the other, is a factual matter." Preamble to Prop. Regs.

Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 77701-01 at 77705, 2003-1 C.B. 373.

The federal tax treatment of costs incurred in a patent infringement suit depends on the nature of the claims. Patent infringement costs are capital if they are incurred for the defense or perfection of title to the patent. On the other hand, patent infringement costs are deductible if they are incurred to protect against infringement of the patent. If the costs are incurred for both purposes, then a direct tracing, if possible, or a reasonable allocation of costs if a direct tracing is not possible, is necessary to determine the proper treatment of the patent infringement costs for federal tax purposes.

Taxpayer incurred litigation costs pursuant to a license agreement with Affiliate to protect the patent Taxpayer licensed. The nature of the claims against the competitor infringing the patent and the counterclaims of the competitor are not those of a dispute of legal title or ownership of the patent, but of a dispute over whether the competitor infringed upon Affiliate's patent and whether Affiliate's patent was properly issued. These challenges do not raise the issue of whether the patent holder is the true owner of the patent. These expenses are deductible as ordinary and necessary business expenses under § 162(a) of the Code.

## CONCLUSION

We conclude that the litigation costs Taxpayer incurred or will incur pursuant to its license agreement with Affiliate in the patent litigation with its competitor are deductible as ordinary and necessary business expenses under § 162(a) of the Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal income tax consequences of any aspect of any transaction or item discussed or referenced in this ruling.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Christopher F. Kane Chief, Branch 3 (Income Tax & Accounting)

CC: