

# WNTS Insight

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## *Tax issues and opportunities in technology litigation judgments and settlements*

### *In brief*

An increasing number of lawsuits are being filed by technology companies against competitors based on claims such as patent infringement, unfair competition, fraud, and breach of contract. Taxpayers involved in such litigation should be aware that a number of factors affect the tax treatment of payments paid or received as a result of lawsuits. Further, taxpayers should consider other tax consequences of these settlements.

Tax implications of litigation costs and settlements may be overlooked in the process of these claims, which can stretch out over a long period of time. Because the taxation of litigation outcomes is influenced by the parties' pleadings (such as the complaint), as well as the grounds for settlements or judgments, corporate tax functions should engage proactively with the company's general counsel regarding ongoing actions.

### *Tax impact on recipients*

The tax characterization of amounts received from litigation, settlement, or similar disputes is based on the origin of the claim. Payments being received can represent ordinary income, capital gain, reimbursement for damaged assets, or other treatment depending on the nature of the litigation.

For example, in the patent infringement context, courts have viewed amounts received as recovery of lost profits (i.e., ordinary income) or as a payment to restore lost goodwill (i.e., capital gain) of the taxpayer due to the anticompetitive action of



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the other party. Depending on the nature of the litigation, payments received may represent anything from currently taxed ordinary income to permanently deferred recovery of damage to capital assets.

Taxpayers receiving payments may assume that all proceeds represent taxable income, even though the primary nature of the litigation may be to restore the taxpayer to the position it was in prior to the harm occurring. Courts often recognize that payments designed to restore a taxpayer to the position it was in prior to the harm do not represent a taxable accession to wealth under section 61 but rather represent a nontaxable recovery of capital.

For example, if damages are intended to compensate a party for an injury to a particular asset, such as goodwill, the proceeds are viewed as generally representing a recovery of capital that is not taxable if there is tax basis in the asset to absorb the recovery. Recovery of damage to a capital asset that exceeds tax basis in the asset generally is characterized as capital gain.

**Note:** Although a claim for lost profits generally results in ordinary income, the courts have recognized that profits can be used to measure the damage to a capital asset that the taxpayer has experienced.

Other related items for recipients to consider include:

**Section 199:** Does any portion of the recovery represent qualified production activities income (QPAI) for purposes of the section 199 domestic production deduction?

**Section 186:** If the recovery relates to a patent infringement, breach of contract, or antitrust action does the recovery qualify for the special exclusion provided for in section 186?

**Intercompany transfer pricing -- Reg. sec. 1.482-7:** Is the payment received (and related expenses) subject to inclusion in a qualified cost sharing arrangement (QCSA) as either a cost offset or income to the parties to the QCSA?

**Section 111:** Does the recovery represent a recovery or reimbursement of a prior deduction that did not give rise to a tax benefit?

The timing of inclusion in income by the taxpayer is governed by section 451. Typically, inclusion will be when the taxpayer has received the cash or has a fixed right to receive an amount that has been finally determined by the court or other body and is not subject to further appeal or contest. In certain cases, settlements can be enforced notwithstanding further appeal rights on other claims or related action, so it is important for taxpayers to analyze the status of the particular judgment to determine the timing of income inclusion.

## ***Tax impact on payors***

Taxpayers engaged in a trade or business generally may deduct settlement payments (including punitive damages) under section 162. However, there are certain classifications of payments that are nondeductible under sections 162(c), (f), and (g).

For accrual-basis taxpayers, economic performance occurs for liabilities arising out of any tort, breach of contract, or violation of law upon payment. In this situation, a

deduction may be claimed only in the year a payment occurs (as opposed to the signing of a settlement agreement or the issuance of a judgment). Even if the settlement or judgment may be contested through appeal, the timing of deduction may be accelerated in certain instances by the use of a contested liability fund under section 461(f) or through the use of a Qualified Settlement Fund governed by section 468B.

Other related items for payors to consider include:

Sections 162(c),(f),and (g): Does any portion of the payment represent nondeductible bribes, kickbacks, fines, penalties, or antitrust damages?

Section 263(a): Does any portion of the payment represent a capitalized intangible?

Section 1341: Does the payment represent a repayment of income that the taxpayer previously reported as income under the claim of right doctrine?

Intercompany transfer pricing -- Reg. sec. 1.482-7: Is the payment made (and litigation-related expenses) subject to inclusion in a QCSA or otherwise attributable to a related party?

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