The Perils of Winning: Settlement Payments, Trade Secrets, and Taxes

by Tom Crice

Summary

A recent U.S. Appeals Court case, *Freda, et al. v. Commissioner,* 656 F.3d 570 (7th Cir. 2011), vividly demonstrated that, when it comes to civil litigation, winning a large award is just half the battle. Keeping it is the other half. After nearly a decade of litigation the taxpayer in *Freda* had finally collected $26.1 million in damages, of which $15.2 million was a settlement payment. But then round two began, this time with the Internal Revenue Service, and when almost a decade later it was finally over the taxpayer was poorer by more than $700,000. As can so often be the case, looking back one thing is certain: things didn't have to go that way. Had the taxpayer planned from the beginning for the tax consequences of victory he might have spared himself those extra years and saved all that money.

In *Freda*, a divided Court affirmed the Tax Court's decision that the taxpayer had wrongly characterized the settlement payment, paid on his claim alleging misappropriation of his trade secret asset, as capital gain. The Court based its ruling on three specific conclusions of law. First, the Court rejected the taxpayer's argument that any damages paid on a claim involving a trade secret asset necessarily constituted capital gain. Second, the Court held that the taxpayer had the burden to establish what portion of the settlement payment had been paid for other than "lost profits or other items taxed as ordinary income". Third, the Court ruled that the capital gains treatment generally afforded to "holders" of patents by I.R.C. §1235 was not available to the taxpayer on the particular facts of this case.

The Court's opinion in *Freda* demonstrates that civil litigants are well advised to remember that they are also taxpayers. Their causes always have not one but two stages. The first encompasses the resolution, for better or worse, of the underlying damage claims. Afterward, they must face the tax consequences that accompany that resolution. As we shall see below, real victory is achieved by conducting the first round with a plan for the second.

The Facts

In the early 1980's, C&F Packing Co., Inc, (hereafter, "C&F"), owned by Mr. Joseph Freda and others, was an S corporation with a very good idea. Engaged in the business of meat processing, C&F had developed a new method of freezing pre-cooked sausage that improved both its appearance and taste when later thawed and consumed. C&F obtained a patent for this process and subsequently developed further improvements to the process. Those later improvements were held by C&F as trade secrets. Pizza Hut, Inc., recognizing a good thing when it saw it, entered into a contract with C&F to purchase large quantities of sausage prepared using its proprietary intellectual property. In order to assure product consistency nationwide, however, Pizza Hut insisted that C&F share its trade secrets with both Pizza Hut and certain of its other sausage suppliers. For its part Pizza Hut promised not to disclose any of C&F's trade secrets.[1]

According to C&F's complaint, in spite of this contract Pizza Hut eventually took their relationship in a very different direction. Turning to another of its suppliers, Iowa Beef Processors ("IBP"),[2] Pizza Hut allegedly handed over C&F's trade secrets. Thereafter, IBP implemented the C&F method, produced large quantities of sausage, and sold it to Pizza Hut at a lower price than C&F was charging. Not surprisingly, Pizza Hut then reduced the amount it purchased from C&F.

C&F's profits declined and in 1993 it filed suit against both IBP and Pizza Hut for misappropriation of its trade secrets, claiming as damages "among other things, lost profits, lost opportunities, operating losses, and expenditures." There followed a long and tortuous litigation, lasting more than a decade, during which all the allegations against Pizza Hut were at one point dismissed. Finally, C&F had its day in court against IBP and the jury awarded C&F $10.9 million dollars in damages. After being affirmed on appeal, in 2000 IBP paid that judgment in full.[3] On its federal tax return for that year C&F reported $2.86 million of the award as ordinary income from lost profits restitution, and the remaining $8.04 million as long-term capital gain.[4] That allocation was not challenged by the IRS.

In addition to the judgment against IBP, C&F had another victory to celebrate: the Federal Circuit had reinstated its claim against Pizza Hut alleging trade secret misappropriation, and remanded the case to the Northern District of Illinois.[5] Pizza Hut promptly moved for summary judgment and lost, then in January 2002 moved to settle. In the usual way, Pizza Hut admitted no fault while paying C&F $15.2 million, which the settlement agreement described as "a lump sum payment in full and complete discharge and settlement of the Lawsuit and all other past, present and future claims that could be asserted now or in the future…"

After paying attorneys' fees, expenses, and a lump sum to a former shareholder, C&F walked away with $6.12 million in cash. On its 2002 federal tax return C&F characterized this entire amount as long-term capital gain. And that was the seed from which all its subsequent tax trouble grew.

In March 2007, C&F received deficiency notices from the IRS. The Commissioner had recharacterized the entire Pizza Hut settlement payment as ordinary income and accordingly the

S corporation’s shareholders now owed more than $700,000 in additional tax.[6] Naturally, C&F objected but eventually the IRS position was sustained in the Tax Court.[7] And by its decision August 26, 2011, just about nine years after C&F took its pound of flesh from Pizza Hut, the Seventh Circuit, splitting two to one, upheld the Tax Court’s determination.[8] The C&F shareholders were on the hook for all those extra taxes.

The Economic Value of a Trade Secret

Arguably, from an economic point of view the monetary value of a depreciable asset at any particular moment in time equals the present value of all the future earnings that will eventually arise from it. As time rolls forward the asset transforms that future potential into current, ordinary income. As a result, the present value of what remains to be earned (the asset’s “value”), declines. Eventually there is nothing left but the salvage value and, in the case of intangible assets, not even that.

In practice, the valuation of such an asset’s as discounted, anticipated cash flows is only an estimate, a number that depends entirely on the economic assumptions and methods used by those doing the calculation. As a result, the sale of such an asset occurs when the buyer’s valuation model implies an expectation of discounted future income streams sufficiently in excess of that suggested by the seller’s model. On exchange of the underlying asset the amount received by the seller, less any basis, is frequently taxed as capital gain.[9]

A trade secret is precisely this sort of business asset. Its owners can use it to produce current ordinary income, generally through personal use (so as to preserve the secret) or as C&F did, through licensing. While future earnings could come from such continued use the owners might instead decide to sell it to someone who values it more. They could do so, that is, as long as the secret they hold stays a secret. Unlike many other income producing assets, a trade secret's value is severely reduced, perhaps completely destroyed, by the mere act of disclosure.

And as the *Freda* case demonstrates, that's the danger of sharing a trade secret with other parties, no matter how much you try and protect against improper use or disclosure with contractual covenants. As Yogi Berra is alleged to have said, "It's not you I don't trust to keep a secret. It's the people you're gonna tell I don't trust."

The Law

A. The Tax Character of the Trade Secret Asset

Under the "substitute for ordinary income" doctrine announced by the Supreme Court in *Comm'r v. P.G. Lake, Inc.*,[10] where a taxpayer receives a lump sum payment in exchange for future, ordinary income that lump sum is itself ordinary income. For example, the lottery winner who takes his prize as a single payment instead of an annuity has realized ordinary income and not capital gain on the amount by which his prize exceeds the cost of his ticket.[11]

From an economic perspective, the future income stream associated with a trade secret asset is arguably no different from that of the lottery winner's annuity, albeit with different risks attached. In either case, when sold the amount paid represents the present value of the future income stream the buyer expects to be produced. For the seller, the payment received is a substitute for that future ordinary income and therefore, absent statutory exception, is ordinary in character.

Happily, the Internal Revenue Code provides precisely the exception needed. First, the Code expressly defines a trade secret to be a member of that group of intellectual property collectively known as an "intangibles".[12] Second, the Code declares all members of the intangible family to be depreciable property, subject to all the same rules as other types of depreciable property.[13] Costs incurred while creating a trade secret may be immediately expensed[14], claimed as a tax credit[15], or capitalized to basis and amortized over a sixty month period.[16]

Finally, note that as depreciable property used in a trade or business, a trade secret not a capital asset.[17] The day is saved again, however, by force of I.R.C. §1231, which provides that the gain on disposition of a depreciable asset used in a trade or business and held longer than one year qualifies for long-term capital gain treatment while any resultant loss is recognized as ordinary.[18]

In addition, a trade secret may in many cases have sufficient novelty and non-obviousness to qualify for a patent in its own right, save for the fact that its owner has elected not to file an application.[19] Therefore, a trade secret may qualify for treatment as a "patent" under I.R.C. §1235[20] and so be eligible for the long-term capital gain treatment afforded patents on proper disposition by a qualified holder, i.e., a creator or an early investor.[21] That favorable treatment, however, is available only for income arising from a "transfer…consisting of all substantial rights…or an undivided interest therein". An undivided interest exists when the transferee owns "the same fractional share of each and every right in the patent", and exploitation of it cannot be limited geographically or by field of use.[22] The regulations, however, specifically permit a holder to retain sufficient interest in the patent so as to render a purchase agreement enforceable.[23]

B. The Taxation of Damage Awards and Settlement Payments

Determination of the tax character of damage recoveries, whether received on settlement or pursuant to judgment, always begins with a single question: "In lieu of what were the damages awarded?"[24] This is, in essence, the "Origin of Claim" doctrine, which declares that income received as damages should, absent a statutory exception, be taxed in the same manner as "the right compromised".[25] For example, damages paid as restitution of profits constitute ordinary income while those paid for impairment of a capital asset may be added to basis.[26]

In general, income from all sources, including damages paid on settlement, is taxable on receipt absent an applicable exception. Moreover, income is by default characterized as ordinary and must be shown to qualify for the capital gain treatment.[27] And the burden of establishing that status is placed squarely on the taxpayer.[28]

Analysis of *Freda*

C&F argued that "[t]he nature of the claim itself – not a reference to lost profits as a measure of damages – controls the tax treatment of the settlement proceeds" and that "[a]ll monetary damages that flow from a claim for misappropriation of a trade secret are capital gain because the trade secret is a capital asset…A claim for misappropriation of a trade secret is, by definition, a claim for damage to a capital asset, and no further proof is required." [29]

On appeal, a majority of the Court declined to adopt that recommended *per se* rule and rightly so. First and foremost, a trade secret is not a capital asset. Per I.R.C. §197 it is a depreciable, ordinary asset used in a trade or business, exactly the sort of thing that I.R.C. §1221(a)(2) excludes from the category of capital assets. Much of the confusion surrounding matters involving §197 intangibles begins with this fundamental mischaracterization. Of course, if a trade secret asset were sold after being held more than a year, by the grace of I.R.C. §1231 the resultant gain (in excess of recapture income) would be taxed at the lower long-term capital gain rate. And while that is certainly a good result for the taxpayer it does not transform the tax character of the underlying asset. Thus, C&F's argument, taken on its own terms, was simply not a correct or relevant position with respect to the trade secret asset at the center of this tax controversy.

Second, trade secrets are by nature assets used in a trade or business to produce current, ordinary income. Therefore, in a situation where a trade secret owner such as C&F is injured, the damages arise potentially from two distinct elements of economic value: loss of current income, and a reduction in the present value of all the future income yet to be realized. The former represents lost profits while the latter is damage to an asset used in a trade or business. Accordingly, the Origin of Claims question had to be asked: In lieu of what did Pizza Hut pay C&F all that money? The burden of answering, of course, lay with C&F.

As is customary when applying the Origin of Claims doctrine, the *Freda* majority, as had the Tax Court before it, looked to C&F's complaint to see what damages it had sought to recover. And in the complaint against Pizza Hut the Court found this language: "lost profits, lost opportunities, operating losses and expenditures".[30] And elsewhere the complaint's factual allegations against Pizza Hut included the misappropriation's impact on current sales, earned margins, and other financial consequences.[31]

The way the majority in *Freda* saw it, that language encompassed far more than just damage to the trade secret asset itself and so the Court held that "the tax court did not err when it concluded that the shareholders 'failed to carry their burden that [the settlement payment] did not represent damages for lost profits or *other items taxed as ordinary income*.' "[32] After all, C&F

had a trial in the Tax Court at which, presumably, it had presented all the evidence it felt relevant. According to both the Tax Court and the majority on appeal, that record failed to show what portion of this settlement payment was entitled to capital gain tax treatment. And without a basis in the record, the majority was loathe to find the sort of error that would justify overturning the Tax Court's decision.

The dissent was more charitable, at least to C&F. First, it accused the Tax Court of having wrongly read the complaint to indicate that "C&F was only seeking lost profits against Pizza Hut".[33] Second, the dissent believed that since C&F could have lost profits only to IBP, Pizza Hut's entire liability must have arisen entirely from damage its disclosure had done to the trade secret asset.[34] Given that posture, the dissent found that C&F had, however incidentally, managed to establish that the entire Pizza Hut settlement payment was entitled to capital gain treatment.

But the dissent was probably mistaken to suppose that C&F's damages could only arise from two sources, i.e., lost current profits and a reduction in the trade secret's asset value. For example, C&F, having allocated its production capabilities to meet Pizza Hut's demand, may have stopped seeking new customers. C&F may have hired new workers or otherwise expanded operations. And if those expansions were financed by loans the interest expense and opportunity costs incurred could be recoverable damages, as would additional production materials purchased and stored as inventory. Certainly, the language of C&F's complaint included these and other possibilities, claiming damages for both "expenditures" and operating losses.

Because it attempted to rely only on a mistaken notion of the tax character of trade secrets, however, C&F did not present in the Tax Court any evidence by which these questions and others like them might have been answered. Nor was there included in the settlement agreement any statement as to how C&F or Pizza Hut viewed the character of the payment. Thus, while the dissent in this case was willing to make an inference from the available facts in favor of C&F, the majority was not.

In the alternative, C&F also proposed that I.R.C. §1235 also permitted the Pizza Hut settlement payment to be taxed as capital gain. That Code section permits the gain from the sale of a patent (or a "patentable" trade secret)[35] to be taxed as capital gain provided the seller is a qualified holder who transfers "all substantial rights".[36] In C&F's view, Pizza Hut's misappropriation of its trade secret asset was at least constructively such a qualifying transfer, with the settlement payment being the amount received in return. Unfortunately, C&F's fundamental misunderstanding of the tax character of its asset once again confounded its argument.

Recall once more that C&F's trade secret was a depreciable asset[37] held longer than one year and used in its trade or business. As such, *any* disposition for gain would have entitled C&F to capital gain tax treatment, or at least that part in excess of any recapture income.[38] Thus, C&F did not have to convince either the Tax Court or the Appellate Court that the specific, limited, and highly technical "transfer" requirements of §1235 had been met.[39] It needed only to show that the wrongful disclosure of a trade secret *amounted to* a taking functionally equivalent to a sale, a far easier standard to meet.

The confusion here is all the more unfortunate since the majority in *Freda* did not reject out of hand the notion that misappropriation of a trade secret could, in fact, be a constructive sale of sorts.[40] To the contrary, on review the *Freda* majority seriously considered the question, ultimately finding that the successful lawsuit against IBP demonstrated that C&F retained an interest in the trade secret, subsequent to Pizza Hut's disclosure, that disqualified it from §1235 treatment.[41] Framing its argument more in keeping with the true nature of this trade secret asset very likely would have aided C&F in its quest for tax relief.

Conclusion

From a tax point of view, money received in settlement of a lawsuit is income, no different than money earned from a business, at a job, or by investing. Determining the tax character of a settlement payment, however, begins by asking the question, "In lieu of what were the damages awarded?" Where intangible assets are involved the answer may well be lost in confusion. The *Freda* case provides painful lessons and useful guidance that a successful plaintiff can use to avoid both unnecessary taxes and years of litigation.

First, plan for success by setting forth in the complaint the damages sought with an eye to the potential tax consequences of victory. Are you really seeking lost, current profits or instead recompense for damage to an asset's future earning potential?[42] Are you trying to recoup expenses that should not have been incurred and opportunities wrongly foregone? Make your choices carefully. Years afterward they may well be scrutinized by the Internal Revenue Service, the Tax Court, and on appeal.

Second, where there is a mixture of ordinary and capital type claims, recognize that the winning party has the burden of establishing what portion is entitled to treatment as capital gain. Don't make do with boilerplate in the settlement agreement. Instead, include language stating the parties' understanding as to "in lieu of what" the payment has been made.[43] Building a clear record that supports your tax position regarding the settlement payment before moving on is the best way to ensure you leave the past behind.

Finally, understand the economics of the intangible asset at issue, and where it fits into the statutory scheme. As *Freda* demonstrates, arguing that depreciable, income producing property is a capital asset, or that any settlement payment made in recompense of damage to such an asset, is *per se* capital gain simply will not carry the day.

Like most things in life, when it comes to settlement payments a bit of prevention by way of tax planning is far better than the protracted, expensive, and uncertain cure by litigation that might otherwise be required down the road. After all, winning is supposed to be a good thing.

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[1] To further protect itself, C & F also entered into confidentiality agreements directly with those other suppliers.
[2] IBP was one of the largest meat processers in the United States and, not incidentally, one with whom C & F had no signed confidentiality agreement.
[3] *C&F Packing Co., Inc. v. IBP, Inc.*, 224 F.3d 1296 (Fed. Cir. 2000).
[4] As an S corporation, that income and characterization was passed on to C&F's shareholders.
[5] *C&F Packing, Co. v. IBP, Inc.*, 224 F.3d 1296 (Fed. Cir. 2000).
[6] The portion of the settlement paid to the former shareholder, although an issue before the IRS, was resolved and did not play a role in the Tax Court or on appeal to the Seventh Circuit.
[7] T.C. Memo 2009-191.
[8] *Freda, supra* at 577.
[9] Depreciable assets used in a trade or business and held for more than one year are eligible for long-term capital gain or ordinary loss treatment on their sale. *See* I.R.C. §1231(a), (b). Certain non-depreciating assets (excepting copyrights in the hands of those whose personal efforts created them) may also qualify for long-term capital gain treatment. *Ib*.
[10] 356 U.S. 260 (1960).
[11] *See, e.g., Prebola v. Comm'r*, 482 F.3d 610 (2nd Cir. 2007); *Watkins v. Comm'r*, 447 F.3d 1269 (10th Cir. 2006); *Davis v. Comm'r*, 119 T.C. 1 (2002).
[12] I.R.C. § 197(d)(1)(C)(iii).
[13] I.R.C. § 197(a), (f)(7).
[14] I.R.C. § 174(a)(provided the expenditure qualifies as "research and experimental" and the project passes the uncertainty test). *See also* Treas. Reg. 1.174-1, 1.174-2.
[15] I.R.C. § 41 (available only if the particular process meets the relevant requirements and tests).
[16] I.R.C. § 174(b).
[17] I.R.C. § 1221(a)(2)(statutory definition excludes depreciable and real property used in a trade or business).

[18] I.R.C. § 1231(a), (b). Note that gain in excess of the adjusted basis will be §1245 (or §1250) recapture income up to the depreciation taken, with the excess receiving long-term capital gain treatment. Amounts deducted pursuant to §174, however, are not subject to recapture. *See* Rev. Rul. 85-186.
[19] Owners may opt for trade secret status over patent protection since a patent's legal protection will end someday while the trade secret can remain viable as long as it is not disclosed. In addition, patents require public disclosure of the technology.
[20] The tax advantages of §1235 are available to any "patentable product" or "patentable invention" and does not require actual issuance or even that an application to be patent be filed. It is sufficient that the "know-how" be potentially patentable. *See* Treas. Reg. 1.1235-2; *Gilson v. Comm'r*, 48 TCM 922, T.C. Memo 1984-447.
[21] I.R.C. § 1235(a), Treas. Reg. 1.1235-2(d); *see also Vision Info. Servs., LLC v. Comm'r*, 419 F.3d 554 (6th Cir. 2005); *Pickren v. United States*, 378 F.2d 595 (5th Cir. 1967); *Liquid Paper Corp. v. U.S.*, 2 Ct. Cl. 284 (1983).
[22] Treas. Reg. 1.1235-2(c).
[23] Treas. Reg. 1.1235-2(b)(2).

[24] *Raytheon Production Corp. v. Comm'r*, 144 F.2d 110 (1st Cir. 1943). *See also United States v. Gilmore*, 372 US 39 (1963); *United States v Patrick*, 372 US 53 (1963); *Hort v. Comm'r*, 313 US 28 (1941).
[25] *Canal-Randolph Corp. v. United States*, 568 F.2d 28 (7th Cir. 1977); *Nahey v. Comm'r*, 196 F.3d 866 (7th Cir. 1999); *Alexander v. Internal Revenue Service*, 72 F.3d 938 (1st Cir. 1995).
[26]*United States v. Gilmore, supra; Woodward v. Comm'r,* 397 U.S. 572 (1970).
[27] *Comm'r v. Gillette Motor Transp., Inc.*, 364 U.S. 130 (1960); *Womack v. Comm'r*, 510 F.3d 1295 (11th Cir. 2007).
[28] *See, e.g., Morse v. United States, 371 F. 2d 474 (1967); Helvering v. Taylor, 293 U.S. 507 (1935); Rockwell v. Comm'r*, 512 F.2d 882 (9th Cir. 1975); *Messer v. Comm'r*, 438 F.2d 774 (3rd Cir. 1971).
[29] *Freda, et al. v. Comm'r*, 2010 W.L. 3948579 (C.A. 7), Appellate Brief *at* p. 11.
[30] *Freda, et al. v. Comm'r*, 656 F.3d 570, 574 (7th Cir. 2011).
[31] *Freda* at 575.
[32] *Freda* at 575-76 (emphasis in the original).
[33] *Freda* at 579.
[34] *Freda* at 578.
[35] Treas. Reg. 1.1235-2.
[36] I.R.C §1235(a), (b).
[37] *See* I.R.C. §197(f)(7).
[38] I.R.C. §§1235, 1245, 1250.
[39] That is, the transfer was of all substantial rights, or of an undivided interest including all such rights, by a qualified holder to a qualifying buyer. I.R.C. §1235(a), (b).
[40] *Freda*, at 567-77.
[41] The majority's basis for that rejection is curious since Treasury regulations specifically state that a qualifiying §1235 holder may retain an interest in the transferred patent sufficient to enforce any purchase agreement. *See, e.g.*, Treas. Reg. 1.1235-2(b)(2).
[42] Note that if you calculate damage from the first moment of a trade secret's misappropriation then all the profits lost subsequently were part of the asset's value at that time. Accordingly, the claim could be appropriately characterized as for damage to a capital asset and not necessarily for lost profits.
[43] The author recognizes that settlement often requires that the defendant-payor be allowed to make his payment without admitting culpability. None-the-less, it is still possible for the settlement agreement to state for which alleged damages the payment is made. For example, in *Freda* language such as "While Pizza Hut admits no wrongdoing, it does agree to pay $16.2 million to settle the claim of damages to

C&F's trade secret asset, such payment being in full settlement of all C&F's claims" could have worked nicely.