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Governor

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TAXPAYER INFORMATION RULING LR13-004

April 29, 2013

This taxpayer information ruling (TIR) is in response to your request dated February 23, 2012, as supplemented by your June 15, 2012 and November 30, 2012 correspondence. You ("Representative"), requested, on behalf of your unnamed client, . . . ("Client"), that the Arizona Department of Revenue ("Department") issue a ruling addressing Arizona's corporate income tax characterization of expected proceeds resulting from a court ordered judgment in a patent infringement lawsuit ("Expected Judgment Proceeds").

ISSUE:

Should the Expected Judgment Proceeds be characterized as business income or nonbusiness income for Arizona corporate income tax purposes?

RULING:

Based on the facts and documentation provided, the Department rules that the Expected Judgment Proceeds are business income to Client and the Arizona Affiliated Group in accordance with A.R.S. § 43-1131(1), Arizona Administrative Code ("A.A.C.") R15-2D-506, and Arizona Corporate Tax Ruling CTR 94-12.

FACTS PROVIDED BY REPRESENTATIVE:

The following facts are excerpted from Representative's February 23, 2012 letter:

1. Client is a corporation that files as part of an Arizona consolidated return with its Parent (collectively, the "Arizona Affiliated Group"). Client develops, manufactures and sells products to customers. As part of its regular trade and business operations, Client also holds patents it developed or acquired for use in its own manufacturing processes and licenses its patents to third-parties. Accordingly, Client earns its revenue from either the sale of its products or patent licensing arrangements.
2. Arizona Affiliated Group develops, manufactures and markets innovative products. The developing, manufacturing and marketing of these products requires the Arizona Affiliated Group, as a whole, to develop, acquire and hold patents as part of their business operations. Different entities within the Arizona Affiliated Group are responsible for different product lines.

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3. Client engaged in litigation proceedings against a competing manufacturer ("Defendant") in Client's industry alleging patent infringement. Client's patent covers certain products it manufactures and holds for sale to customers.
4. Client alleged Defendant's competing products were covered by Client's patent. The infringement of Client's patent caused Client to lose profits and, assuming Defendant does not cease certain unauthorized activities, Client expects to lose future profits.
5. Client acquired the patent at issue from a third-party.
6. Client was awarded judgment in the patent infringement lawsuit. The court ordered Defendant to pay Client damages in the form of a specified lump sum. Client has not yet received payment for damages, but expects to receive the award subject to pending appeals. The award is intended to compensate Client for its lost profits, reasonable royalties, plus punitive damages, attorney's fees and interest resulting from Defendant's manufacture, distribution and sales of infringing products in 2011 and prior years.
7. Client has not entered into and does not intend to enter into a traditional patent licensing arrangement with Defendant. However, as part of the judgment, Client must provide Defendant with the ability to continue using its patent in exchange for future royalty payments based on a percentage of Defendant's infringing sales, until the patent expires.
8. Client expects to receive a lump sum payment and potential future payments contingent upon Defendant's continuous use of Client's patent (together, the "Expected Judgment Proceeds").

The following facts are excerpted from Representative's June 15, 2012 letter:

1. Client does not intend to enter into a traditional licensing arrangement because Defendant would not enter into such an agreement.
2. Currently, the Arizona Affiliated Group holds 931 patents; 201 of which are held by Client.
3. The Arizona Affiliated Group acquired 294 patents; 28 of which were acquired by Client.
4. The Arizona Affiliated Group developed 637 patents; 173 of which were developed by Client.
5. Generally, Client uses all of its own patents in its own business.
6. Generally, the Arizona Affiliated Group uses all of its own patents in its own business.
7. The Arizona Affiliated Group has defended five or six patents in court. Client has defended one patent in court.

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8. Client and the Arizona Affiliated Group were successful in defending all the patents to date. The Arizona Affiliated Group has two lawsuits pending. The Client has no lawsuits pending.
9. Client and the Arizona Affiliated Group have defended all patents through court action.

The following facts are excerpted from Representative's November 30, 2012 letter:

1. The subject patent was acquired in 2007. Client paid for the exclusive right to use the patent beginning in the 1980's and maintained it until Client acquired the patent in 2007. This exclusive licensing arrangement included enforcement rights to protect against patent infringement.
2. Defendant infringed upon the patent from 2002 until the present.
3. The patent is currently licensed to two third parties. The patent is not currently licensed to another member of the Arizona Affiliated Group. The patent has not been licensed to anyone else.

DISCUSSION & LEGAL ANALYSIS:

A. The Expected Judgment Proceeds are earned in the regular course of Client's business operations.

A.R.S. § 43-1131(1) defines business income to mean "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

Client's regular trade and business operations include developing, acquiring and holding patents. Client earns its income by using patents in its business of manufacturing products for sale to customers and by licensing its patents to third parties. Client's revenues from its regular business activities include those from sales and royalties. A.A.C. R15-2D-506 provides that "[p]atent and copyright royalties are business income if the patent or copyright with respect to which the taxpayer receives royalties arises out of or is created in the regular course of the taxpayer's trade or business operations or if the purpose for acquiring and holding the patent or copyright is related to the trade or business operations." Client's royalties are all business income because the patents that gave rise to the royalties were all either created or acquired in its regular trade or business. The Expected Judgment Proceeds are the result of loss of business or royalties resulting from the patent infringement of a particular patent that was acquired by Client for use in its regular trade or business. Therefore, the Expected Judgment Proceeds should be treated the same as royalties earned from the same patent.

Client's ability to generate revenue and earn a profit is contingent upon effectively managing its patents. Client does not conduct other operations separate from the

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operations governed by its patents. Therefore, Client's Expected Judgment Proceeds are business income for Arizona corporate income tax purposes.

B. The Expected Judgment Proceeds are included in business income for Arizona corporate income tax purposes because it represents business income to Client's Arizona Affiliated Group.

In determining whether income is business or nonbusiness, Arizona Corporate Tax Ruling CTR 94-12 states that "one may look to a single corporation, a part of a corporation, or a group of corporations sufficiently integrated to constitute a business."

The facts provided by Representative establish that the Expected Judgment Proceeds are integral to Client's business on a standalone basis. Therefore, the Expected Judgment Proceeds are integral to at least part of the Arizona Affiliated Group's business. While viewing Client's business on a standalone basis leads to the conclusion that the Expected Judgment Proceeds are business income, the same conclusion is reached when viewing the transaction in the context of Client's Arizona Affiliated Group as a whole.

Because patents are essential to the products manufactured and sold by the Arizona Affiliated Group, they develop, acquire and hold these patents in the regular course of their business. The income derived from the patents is integral to the group's manufacturing and distribution business operations, and is at the core of the group's income-producing capability. Therefore, the Expected Judgment Proceeds are characterized as business income for Arizona corporate income tax purposes.

The conclusion in this TIR does not extend beyond the facts presented in Representative's correspondence dated February 23, 2012, June 15, 2012, and November 30, 2012.

This response is a taxpayer information ruling (TIR) and the determination herein is based solely on the facts provided in your request. The determinations are subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the Department's making of an accurate determination, this taxpayer information ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law, or notification of a different Department position.

If the Department is provided with required taxpayer identifying information and taxpayer representative authorization before the proposed publication date (for a published TIR) or date specified by the Department (for an unpublished TIR), the TIR will be binding on the Department with respect to the taxpayer that requested the ruling. In addition, the ruling will apply only to transactions that occur or tax liabilities that accrue from and after the date the taxpayer receives the ruling. The ruling may not be relied upon, cited, or introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the taxpayer information

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ruling. If the required information is not provided by the specified date, the taxpayer information ruling is non-binding for the purpose of abating interest, penalty or tax.

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