***10 T.C. 1099 (1948)***

Awards received from patent infringement lawsuits are generally treated as taxable income, not as a non-taxable return of capital, unless proven to be compensation for a specific capital loss demonstrated in the infringement suit.

**Summary**

Nicholas Mathey sued United Shoe Machinery Corporation for patent infringement and received a judgment, which the Commissioner of Internal Revenue sought to tax as ordinary income. Mathey argued the award was a non-taxable return of capital, compensation for an involuntary conversion, or eligible for special tax treatment under Section 107(b). The Tax Court held that the award represented compensation for lost profits, not a return of capital or compensation for the destruction of a capital asset. Further, it did not qualify as an involuntary conversion or meet the requirements for special tax treatment under Section 107(b), rendering the award taxable as ordinary income.

**Facts**

Nicholas Mathey, experienced in shoe-manufacturing, patented a machine for trimming leather flaps on wooden heels in 1931. He manufactured and leased these machines. In 1930, Mathey discovered United Shoe Machinery Corporation was leasing a similar machine, infringing on his patent. Mathey notified United of the infringement in 1931 and initiated a lawsuit in 1937, claiming lost profits due to United's actions.

**Procedural History**

The District Court ruled in favor of Mathey in 1940, finding patent infringement, issuing an injunction, and ordering United to pay damages and profits. The Circuit Court of Appeals affirmed the District Court's decision in 1941. A master was appointed to determine profits and damages and submitted a report. The District Court confirmed the master's report in 1944 and increased the award due to United's deliberate infringement. United paid the judgment in 1944. The Commissioner then assessed a deficiency, treating the award as taxable income. Mathey appealed to the Tax Court.

**Issue(s)**

1. Whether the proceeds from the patent infringement suit constitute taxable income or a non-taxable return of capital.
2. If taxable income, whether the proceeds should be taxed as ordinary income or as capital gains resulting from an involuntary conversion under Section 117(j).
3. If ordinary income, whether the proceeds can be taxed under the special provisions of Section 107(b).

© 2025 SCOTUSreports.com. All rights reserved. 

## Holding

1. No, because the award compensated for lost profits, not the loss of a capital asset.
2. No, because the infringement did not constitute an involuntary conversion under Section 117(j).
3. No, because Mathey failed to demonstrate that the income received in the taxable year met the 80% threshold required by Section 107(b).

## Court's Reasoning

The court reasoned that the taxability of lawsuit proceeds depends on the nature of the claim and the basis for recovery. The court relied on precedent, including Liebes & Co. v. Commissioner, to establish this principle. The court found that Mathey claimed and recovered lost profits in the infringement suit, not compensation for the loss of a capital asset. Evidence regarding a decline in Mathey's net worth was immaterial because it was not the basis of the recovery in the infringement suit. The court emphasized that the master's allowance for "reasonable royalties" was compensation for lost profits, not a return of capital.

Regarding the increased award, the court determined it was not a penalty but intended to compensate Mathey for lost profits and expenses incurred due to the infringement. The court cited its earlier decision, stating it did not "conceive it to be the intent of the law to unjustly enrich the injured party at the expense of the wrongdoer," but stressed the need for full justice to the wronged party.

The court rejected the argument for involuntary conversion under Section 117(j), stating there was no total destruction, theft, or seizure of the patent. Mathey continued to own and use the patent, generating income from it during and after the infringement. Finally, the court dismissed the applicability of Section 107(b) because Mathey did not demonstrate that his gross income from the invention in the taxable year met the required 80% threshold compared to the total income from the invention in prior years. The court held that costs of development were not deductible from rental charges to arrive at gross income and that installation costs were allowed as deductions in arriving at net income, not gross income.

## Practical Implications

This case clarifies that patent infringement awards are generally treated as taxable income, specifically compensation for lost profits. To argue successfully for non-taxable treatment, a taxpayer must demonstrate that the award was specifically intended to compensate for the loss or destruction of a defined capital asset. Legal practitioners should carefully document the basis of damages claimed in patent infringement suits to ensure proper tax treatment of any resulting awards. This case highlights the importance of substantiating claims for capital losses and meticulously tracking income related to patents to potentially qualify for special tax

© 2025 SCOTUSreports.com. All rights reserved. 

provisions.

© 2025 SCOTUSreports.com. All rights reserved. 