Non-Deductibility Is a Wonderful Thing: Federal Income Taxes Should Not Be Deductible When Calculating Net Profits in a Copyright Infringement Suit

Matthew McNicholas* and John P. McNicholas**

I. INTRODUCTION

Once copyright infringement has been established, section 504 of the Copyright Act[1] provides that the prevailing copyright owner may elect to recover, at any time before final judgment is rendered, either statutory damages, or all actual damages and "'any profits of the infringer that are attributable to the infringement . . . .'"[2] The purpose of these damages is to prevent the infringer from unfairly benefiting from its wrongful act of copyright infringement.[3]

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* Law Clerk to United States District Judge William J. Rea, Central District of California; B.A., with honors, 1994, University of California at Los Angeles; J.D., 1997, Loyola of Los Angeles Law School.

** Adjunct Professor of Law, Loyola Of Los Angeles Law School; B.A., 1958, University of California at Los Angeles; J.D., 1962, Loyola of Los Angeles Law School; Fellow, International Academy of Trial Lawyers; Fellow, American College of Trial Lawyers; Diplomate, American Board of Trial Advocates; Past President, American Board of Trial Advocates; John McNicholas was lead trial counsel for Three Boys Music Corporation, a.k.a. The Isley Brothers, in the successful prosecution of a copyright infringement suit against Michael Bolton and Sony Music, Corp. in the United States Court, Central District of California.

1 All references will be to the 1976 Copyright Act, unless otherwise indicated.

2 4 Nimmer on Copyright, § 14.03 (1997) (citing 17 U.S.C. §504(b).)

3 *Id.*

If the successful copyright holder elects actual damages and attributable profits, the calculation of attributable profits is factually intense and can be very complex. This article examines the calculation of such attributable profits, focusing on the determination of net infringing profits. Specifically, it examines the propriety of deducting federal income taxes, paid or incurred by the defendant on infringing revenues, in the calculation of net infringing profits.

It is important to note that this article does not examine the validity of allowing apportioned damages, or the validity of the mechanics involved in generating such figures. Furthermore, it does not consider or analyze the issue of apportionment of such figures except as how they relate to a deduction for federal income taxes.

The propriety of federal income taxes as an allowable deduction is currently an unsettled issue and is the product of an inter-circuit split.[4] In *Schnadig Corp. v. Gaines Mfg. Co., Inc.*,[5] (hereinafter "*Schnadig*"), the Sixth Circuit held that no deduction is proper under any circumstances, while the Second Circuit held, in *In Design v. K-Mart Apparel Corp.*,[6] (hereinafter "*Design*"), that such a deduction is allowable in situations of non-willful infringement. Both decisions find their legal basis in the United States Supreme Court's holding in *L. P. Larson, Jr., Co. v. William Wrigley, Jr., Co.*,[7] (hereinafter "*Larson*"), a case declining deduction for the willful infringement of a gum package wrapper.[8]

This article reviews the validity of both the Second and Sixth Circuits' holdings, addressing both legal arguments and policy issues. From these arguments, this article recommends adopting the rule of non-deductibility in all infringement scenarios, as espoused by the Sixth Circuit, as the resolution to the inter-circuit split. While the Second Circuit's position has gained support in some district courts, this article will amply demonstrate that the Sixth Circuit's holding represents the better reasoned and more equitable approach to protecting

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[4] The Ninth Circuit is silent on the issue.

[5] 620 F.2d 1166 (6th Cir. 1980).

[6] 13 F.3d 559 (2nd Cir. 1994).

[7] 277 U.S. 97 (1928).

[8] As discussed below, it is unclear whether the "willful" status of the infringer was determinative to the Court's holding in *Larson*.

the copyright holder, and represents the more sound reading of the Supreme Court's holding in *Larson*.

This article will begin with a brief description of the calculation of attributable profits in a copyright infringement suit, and how the deduction of federal income taxes bears on that calculation. It will then present a brief overview of the current inter-circuit split on whether such an income tax deduction is appropriate, starting with the Supreme Court's opinion in *Larson*, and then reviewing the findings of *Schnadig*, from the Sixth Circuit, and *Design*, from the Second circuit. The article will then present a detailed examination of the opinions in these three cases and how they arrived at their holdings. In so doing, the article will focus on two areas. First, it will explain why the Sixth Circuit's holding in *Schnadig* should be adopted, focusing on its analysis of the federal income tax code and its real life effect on copyright infringement suits. Second, it will explain why the holding in *Design* should be rejected, focusing on its shortcomings and analytical failures.

The net result is that this article supports the position that federal income taxes should not be an allowable deduction in the calculation of net infringing profits in any copyright infringement suit.

II. ANALYSIS

A. *The Calculation of Attributable Profits is Based on the Trier of Fact's Determination of Apportionment, and the Trier of Law's Determination of Allowable Deductions*

Attributable profits are determined using three distinct figures: (1) the infringer's revenues that are attributable to the infringing work;[9] (2) allowable deductions from such revenues;[10] and (3) apportionment figures.[11] The plaintiff bears the burden of proving infringing revenue

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[9] *See* 17 U.S.C.A. §504(b)
In establishing the infringer's profits, the copyright owner is required to present proof only of the infringer's gross revenue, and the infringer is required to prove his or her deductible expenses and the elements of profit attributable to factors other than the copyrighted work.

[10] *Id.*

[11] *See* 4 Nimmer on Copyright, § 14.03[c] (1997)

only, while the defendant must show what portion of that revenue is attributable to its original work (yielding an apportionment percentage) as well as any allowable deductions.[12]

To calculate net attributable profits, all allowable deductions are subtracted from total infringing revenue, yielding a net profit figure. That net figure is then multiplied by the appropriate apportionment percentage, yielding total net attributable profits. This is the successful copyright holder's award.[13]

A brief example will illustrate this calculation. In *Frank Music Corp. v. Metro-Goldwyn-Mayer Inc.*,[14] defendant MGM Grand Hotel performed selections from the plaintiff's Kimset (the original work) in the defendant's "Hallelujah Hollywood" stage performance in Las Vegas (the infringing work). The Kimset segment was only one of ten total acts in the performance, comprising approximately twelve percent (12%) of the performance's total weekly running time. Seventy five percent (75%) of the Kimset segment was determined to be based on the plaintiff's copyrightable material, while twenty five percent (25%) was attributed to the defendant's own efforts. In awarding the copyright holder its damages, the court found that nine percent (12% x 75%) of the revue's total profits were attributable to the plaintiff's original work, totaling $552,000 after allowable deductions.[15]

When calculating an infringing profit award, the determination of net profits is monumental, in both practical importance and in actual calculation. First, the practical importance lies in the fact that the plaintiff's total award and the defendant's total liability are directly proportional to the infringer's net profit figure. With higher net profits

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The rule of "nonapportionment was modified in *Sheldon v. Metro-Goldwyn Pictures Corp.*, wherein the Supreme Court approved an apportionment of twenty percent of defendant's profits from the motion picture "Letty Lynton" as attributable to plaintiff's work, and hence held plaintiff to be entitled to only that portion of the total profits."

[12] *See* §504(b).

[13] Note that this is the appropriate award so long as this is the measure of damages the copyright holder elected.

[14] 772 F.2d 505 (9th Cir. 1985).

[15] *See* also 4 Nimmer on Copyright, § 14.03 (1997). (discussion of *Frank Music Corp.* example).

comes greater apportioned damages. Second, and as a direct result of this practical importance, the mechanics of calculating net profits are critically important. The defendant, in an attempt to lower the amount of infringing profits that will be disgorged, will seek to establish a low total infringing revenue figure by taking as many "allowable" deductions as possible. The plaintiff, on the other hand, in its attempt to increase its award, will argue to enlarge[16] the total infringing revenue figure by challenging every deduction the infringer seeks.[17]

Unfortunately, when making these calculations, "[n]either the Act nor the Committee Reports specify which expenses will be regarded as deductible costs. . . ," and as with so many other aspects of copyright jurisprudence, the case law has had to offer its own treatment of the issue.[18] Therefore, once revenue and apportionment figures are established, the battle over allowable expenses, as a matter of law, begins.

It should become apparent that high apportionment and revenue figures can be countered by larger allowable deductions, and that low apportionment and revenue figures can be augmented by lower and fewer allowable deductions. Therefore, once the trier of fact has decided apportionment, the lawyers, accountants and experts from all sides will argue for their respective determinations of total infringing revenues according to what they believe should be allowable deductions.

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[16] In actuality, the plaintiff does not argue to "enlarge" the infringing revenue figure, but rather, argues against diminishing such a figure by arguing against the defendant's proposed deductions.

[17] The infringer will also argue for a lower apportionment figure. However, as the determination of apportionment figures is not the focus of this article, the issue will not be discussed.

[18] 4 Nimmer on Copyright, § 14.03[B] (1997).

B. *Summary of the Current Inter-Circuit Split*

1. The Supreme Court Has Held That Federal Income Taxes Are Not An Allowable Deduction In A Case Involving Conscious And Deliberate Trademark Infringers

In *L. P. Larson, Jr., Co. v. Wm. Wrigley, Jr., Co.*,[19] a trademark infringement suit, the defendant gum manufacturer Wrigley Company produced its "Doublemint" gum in a package that was found to have deliberately infringed the Larson Company's "Wintermint" gum package.[20] The trial court was presented with accounting issues, including whether federal income taxes were deductible when determining the infringer's net profits.[21] While the Circuit Court of Appeals upheld the allowance of the deduction, the United States Supreme Court granted writ of certiorari on the issue, and reversed. The allowance for federal income taxes was disallowed.[22]

The Supreme Court framed the issue as follows: "[W]hether, as held below . . . the [infringer] should be allowed to deduct the federal income . . . taxes from the profits with which it is to be charged."[23] In answering "no" for the Court, Justice Holmes stated:

> Even if the only relief that the [defendant infringer] can get is a deduction from gross income when the amount of its liability is finally determined the [plaintiff copyright holder] will have to pay a tax on the . . . profits when it receives them, and in a case of what has been found to have been one of conscious and deliberate wrongdoing, we think it just that the further deduction [of income and excess profits taxes] should not be allowed.[24]

Consequently, the "conscious and deliberate" trademark infringer was denied a deduction for taxes paid when determining its net profits.

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[19] 277 U.S. 97 (1928).

[20] *Larson*, 277 U.S. at 99.

[21] *Id.*

[22] *Id.* at 100.

[23] *Id.*

[24] *Id.* (It should be noted that the Court mentions two deductions the infringer will take; the "further" deduction referred to by the court is actually the deduction of taxes from infringing profits discussed in this paper.)

2. The Sixth Circuit Holds That Federal Income Taxes Are Not An Allowable Deduction Whether Or Not The Infringement Was Conscious And Deliberate

In *Schnadig Corp. v. Gaines Mfg. Co., Inc.,* [25] ("*Schnadig*"), a patent infringement case, the plaintiff's three-piece sectional sofa design was infringed and the plaintiff sought the infringing profits as the measure of damages. When calculating net infringing profits, the district court allowed a deduction for income taxes. The patent holder appealed the order, and the Sixth Circuit reversed, disallowing the deduction of income taxes in all cases of infringement, deliberate or otherwise.[26]

The Sixth Circuit based its holding on two avenues of analysis.[27] First, the court anchored its decision in the realities of the federal income tax system as applied to all infringers. Specifically, it found that infringers are reimbursed for all taxes-paid on infringing income through subsequent deductions from gross income, and that if infringers were allowed the additional[28] deduction from infringing profits, they would actually receive a net gain as a result of their infringement.

The second basis for the Sixth Circuit's decision was its interpretation of the United states Supreme Court's language in *Larson*, quoted above. The Sixth Circuit found that *Larson* did not limit the non-deduction of income taxes to deliberate infringers for two reasons. First, the Supreme Court could not have intended to bestow a net gain upon non-deliberate infringers, and as such, its reference to conscious wrongdoing was only descriptive of the facts in that case, not a limiting principal in its legal holding.[29] The second reason[30] was based on

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[25] 620 F.2d 1166 (6th Cir. 1980).

[26] *See Schnadig*, 620 F.2d 1166.

[27] The analysis employed by the court in *Schnadig* is only briefly mentioned here, but is discussed in greater detail below.

[28] This deduction is in "addition" to the infringe reduction from gross income in an amount equal to the total damages paid by the infringer.

[29] *Schnadig*, 620 F.2d at 1171.

[30] This second reason is mentioned only to provide the court's complete rationale but will not be discussed in this paper. It is the other aspects of the *Schnadig* opinion that will be analyzed in detail and applied to the situation of copyright infringement.

the Sixth Circuit's reading of the patent statutes at issue.

> The remedy in this case is one prescribed by statute, not one to be drawn from the common law. Section 289 authorizes a design patentee to recover 'to the extent of an infringer's total profit.' The statute makes no distinction between willful and negligent infringers for this purpose, but instead provides a single measure of relief applicable to all cases of design patent infringement.[31]

Consequently, the court found a single measure of relief applicable to all cases of design patent infringement, deliberate or otherwise.

3. The Second Circuit Disagrees with *Schnadig* In Finding That Federal Income Taxes Are An Allowable Deduction When Infringement Is Not Deliberate

The counter approach to *Schnadig* is found in the Second Circuit. In the copyright infringement matter of *In Design v. K-Mart Apparel Corp.*, 13 F.3d 559, (2nd Cir. 1994), K-Mart apparel Corp. ("K-Mart") was found liable for copyright infringement for selling certain sweaters bearing the copyrighted "Damask" design, owned by Hukafit Sportswear, Inc. The trial court did not allow K-Mart a deduction for income taxes paid when calculating net infringing profits. On appeal, however, the Second Circuit reversed the trial court's determination, finding that non-willful infringers are entitled to a deduction of federal income taxes paid when calculating net infringing profits. The finding was based primarily on the qualifying language from *Larson*, wherein Justice Holmes stated that " . . .in a case of what has been found to have been one of conscious and deliberate wrongdoing, we think it just that the further deduction [of income and excess profits taxes] should not be allowed."[32]

4. The Net Result Is A Conflict Between The Circuits

The net result is an inter-circuit split on the deductibility of federal income taxes in calculating net profits in infringement suits. The Second Circuit holds that such a deduction is only proper in cases of non-

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[31] *Schnadig*, 620 F.2d at 1171.

[32] Recall that this same language was dismissed by the Sixth Circuit as merely descriptive of the facts rather than limiting the legal principal announced. *Schnadig*, 620 F.2d at 1171.

willful infringement, while the Sixth Circuit holds that no deduction is proper under any circumstances. In the middle lies the Ninth Circuit which is silent on the issue.

Consequently, any party presenting this issue in a trial court under the jurisdiction of the Ninth Circuit is free to make the appropriate deduction arguments to support their client's particular position, on the issue. Unfortunately, though, any determination by the trial court will likely be appealed for further review. The only true issue for consideration, then, is how the Ninth Circuit should rule, and ultimately, whether the United States Supreme Court will find it necessary to resolve the inter-circuit conflict and clarify its holding in *Larson*.

C. A Detailed Analysis Of The Holding In *Schnadig* And Its Rule Of Non-Deductibility

A closer examination of the inter-circuit split is now necessary, focusing first on the strength's of the Sixth Circuit's logic in *Schnadig*, and then analyzing the inherent weaknesses of the Second Circuit's approach in *Design*.

This article's discussion of the rule of law adopted in *Schnadig* occurs in two distinct steps. First, it analyses the logic of the opinion itself, focusing on the Sixth Circuit's common sense application of the federal income tax code and the concomitant effects such code creates when it interacts with the rules of deductibility and nondeductibility, respectively.

Second, this article presents four discussions supporting the holding in *Schnadig*, and the rule of nondeductibility. The first two are extrapolated from the tax deduction hypotheticals discussed in *Schnadig*, the third addresses the potential speculation, in the *Schnadig* hypotheticals, and the fourth explains why generally accepted accounting principals ("GAAP") must be governed and controlled by generally accepted legal principals ("GALP").

1. Analysis Of The *Schnadig* Opinion

Examining the reasoning for the Sixth Circuit's decision reveals sound logic in both law and common sense. The primary and most important aspect of that reasoning lies in the court's analysis of the

economic realities of the federal income tax system and its resulting effects on the infringer and the copyright holder.[33] The secondary and less significant basis for the court's decision lies in its interpretation of the language in *Larson* as descriptive of the facts, not limiting the legal principal it espoused. Each aspect will be addressed in turn.

a. Decisional Basis One: The Real Life Effects Of The Federal Income Tax Code On Infringement Cases

The Sixth Circuit found that if an infringer is allowed to deduct taxes paid or incurred on infringing income when calculating net infringing profits, that infringer can "net as much as the victim, and perhaps even more if the dynamics of the money market are considered."[34] Furthermore, the court found that even if the infringer does not net as much or more than the victim, at the very least, nondeductibility reimburses the infringer for all taxes paid on the infringing income.[35] These interlocking principals are the heart of *Schnadig* and the foundation underlying the rule of non-deductibility.

In general terms, the determination that the infringer can "net as much as the victim, and perhaps even more" is made possible because all infringers are allowed a deduction from gross income in an amount equal to any damages paid in an infringement suit.[36] This occurs regardless of whether or not the court allows a deduction for taxes incurred or paid when determining net infringing profits. Thus, once an infringer pays a plaintiff in an infringement suit, it is allowed a further deduction in an amount equal to that damage payment from its gross income, lowering its tax liability. Two specific examples will illustrate the point.

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[33] *See Schnadig*, 620 F.2d at 1169 (the court had to "appraise the fairness of excluding the amount paid in income taxes from an award of profits").

[34] *Id.* at 1169.

[35] 26 U.S.C.S. §186 (1997)

[36] *Schnadig*, 620 at 1169 (citing I.R.C. § 162) ("While fines and penalties paid by law are not deductible, amounts paid as damages are." See Treas. Reg. 1.162-21, examples (1) and (3).).

(1) Example 1: Net Gain to the Infringer, or Complete Reimbursement to the Plaintiff

Assume that an infringer was found to have made $100 in pre-tax profit[37] from the exploitation of a certain original copyrighted work. Assume also that 100% of the infringing work was attributable to the original. Finally, assume that the income tax paid on that $100 was $25, or 25%.

Under *Schnadig*'s rule of non-deductibility, the following scenario unfolds. The infringer is not allowed a $25 deduction for taxes paid when calculating net infringing profits, and must therefore pay the plaintiff the entire $100. The infringer then deducts $100 from its gross income as the amount paid on the judgment, reducing its taxable income by the same $100 figure. This $100 deduction, at the 25% tax rate, is equal to $25 of tax that does not have to be paid by the infringer, an amount equal to the taxes originally paid, or incurred, on the infringing income. Consequently, the infringer has been fully reimbursed for all income tax liability yet has taken nothing by way of its infringement. Further, the plaintiff copyright holder has received all of the infringing profits attributable to its original work.[38] The end result is that "disallowing consideration of the immediate tax consequences to the infringer does not penalize; it merely assures that the profit to the wrongdoer is fully extracted."[39]

However, under a jurisdiction that rejects the rule from *Schnadig*, allowing a deduction for income taxes paid when calculating net infringing profits, the following scenario of infringer net gain unfolds under the same assumptions put forth above. First, the infringer deducts $25 from gross profits as the amount of taxes paid or incurred, giving the plaintiff copyright holder only $75 in damages. Next, the infringer is allowed a further deduction from its gross income for the $75 it paid in damages to the plaintiff. In the same 25% tax bracket, that $75 deduction is worth $18.75 in forgiven income taxes (25% of $75), which in actuality is a net gain to the infringer. Since, the in-

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[37] This figure also assumes, for simplicity's sake, that all allowable deductions other than one for income taxes paid or incurred have been taken.

[38] *See Schnadig,* 620 F.2d at 1169-71.

[39] *Id* at 1171.

fringer was given an initial deduction to cover the $25 tax liability on the infringing income in the form of a $25 deduction, the $18.75, is in essence, free money. Consequently, the net result is that the infringer has benefited from its illegal activity, while the innocent copyright holder has been deprived of the complete measure of profits attributed to its original work.[40]

(2) Example 2: Complete Reimbursement to the Infringer of All Income Taxes Paid, or Allowing Equal Gain to the Infringer and Original Author

To take the example one step further, as outlined in the Sixth Circuit's opinion, there are certain situations that will yield equal gains to the infringer and original author alike.[41] As above, assume an infringer earned a pre-tax profit of $100 from the use of a certain infringing work, and that 100% of the infringing work was attributable to the original. However, in this example, assume that $50 was paid in income tax on the infringing income as the product of a 50% tax bracket (as opposed to the 25% tax bracket outlined in the preceding examples).

Under the *Schnadig* non-deductibility approach, the tax reimbursement outcome is exactly the same as above. The copyright holder receives all $100 as its damage award, and the infringer deducts such award from its gross income, decreasing its tax liability by $50, receiving full reimbursement.

However, under the counter approach of non-deductibility, the infringer is allowed a $50 deduction from gross profits, paying $50 in net profits to the copyright holder as damages, and taking a corresponding $50 deduction from gross income which is worth $25 in forgiven income tax. Once the copyright holder pays 50% of its award in taxes, the rate assumed for this hypothetical, the copyright holder is also left with $25. The infringer and the copyright holder benefit equally.[42]

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[40] *See Id.* at 1169.

[41] *See Schnadig*, 620 F.2d at 1169 (provides the example being explained here.)

[42] It should be noted that in all of the examples above, the federal government is not deprived of any revenue through the non-deduction of income taxes in calculating net profits and the subsequent deduction of damages-paid from gross income.

Under either example, the Sixth Circuit found the infringer's net gain patently wrong and plainly unfair. An infringer should not be able to garner profit from its infringement and should certainly be prevented from benefiting in a manner equal to the successful plaintiff. Infringers simply should not be rewarded for violating the intellectual property protection laws.[43]

b. Decisional Basis Two:[44] *The Sixth Circuit Reads The Language In* Larson *As Descriptive Rather Than Limiting Its Legal Principal*

Turning from the ramifications of the federal income tax code, the second decisional aspect of the Sixth Circuit's finding in *Schnadig* was based on its determination that the language of *Larson* could not be read as limiting the non-deductibility of federal income taxes to "conscious and deliberate wrongdoing."[45] In footnote 12, the Sixth Circuit stated that "[t]he Court in Larson did not state that conscious and deliberate infringement must invariably be found before pre-tax profits can be awarded, but merely stated that it was 'just' to award pre-tax profits in that case where the infringement was conscious and deliberate."[46]

The Sixth Circuit bolstered its interpretation of the *Larson* language based on the idea that the Supreme Court could not have in-

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"The reciprocal of the infringer's deduction of the award is the [plaintiff's] inclusion of the award in his gross income." *Id.* (citing *Hort v. Commissioner*, 313 U.S. 28, 61 S. Ct. 757, 85 L.Ed. 1168 (1941) (This case "firmly established the principle that payments which are received as a substitute for an item of ordinary income must be treated as ordinary income.). Therefore, what the infringer is relieved of paying, i.e., the reimbursement for taxes paid on the infringing income, the plaintiff copyright holder becomes liable for under its own income tax.

[43] *See Schnadig*, 620 F.2d at 1169.

[44] This second avenue of analysis is far less important than the preceding discussion of tax ramifications. The Supreme Court was faced with a situation of willful infringement in *Larson*, unlike the case of non-willful infringement in *Schnadig*. Therefore, while commenting on *Larson* was analytically sound, it was not necessary for the Sixth Circuit to do so as *Larson* was not binding on its decision.

[45] *Schnadig*, 620 F.2d at 1171 (citing *Larson*, 277 U.S. at 99).

[46] *Id.*

tended an infringer to profit from its infringement through a tax deduction from gross infringing profits. Put simply, the Supreme Court could not have intended an infringer to benefit from its violation willful or otherwise. Therefore, *Schnadig* viewed Holmes' reference to such "conscious and deliberate wrongdoing"[47] "more as descriptive of the facts in that case than as limiting the principle involved."[48]

2. Arguments Supporting *Schnadig* And The Rule Of Non-deductibility

The examples derived from *Schnadig* and discussed above illustrate that non-deductibility represents, at least facially, a very equitable and logical approach to the calculation of net infringing profits. However, as the heart of the Sixth Circuit's opinion in *Schnadig*, and the foundation for the rule of non-deductibility, these scenarios must now be examined more carefully, going beyond their face to uncover the foundational policies and strengths that underlie the rule of non-deductibility.

a. Non-Deductibility Does Not Allow an Infringer to Gain

At its most basic level, the rule of nondeductibility prevents the infringer from yielding any economic gain, reimburses it for all tax liabilities incurred on the infringing income, and provides the copyright holder with all of the infringing profits the trier of fact attributes to the original work. As such, all parties are put in the same position as if the use of the original work had been licensed or contracted for in that the infringer derives no improper or illegal gain. Put another way, the infringer is completely disgorged of any illegal benefit received through its infringement.

For the law to allow otherwise is tantamount to advocating gains for infringement, or to hold that such gains are necessary as a result of an imperfect system. The former certainly cannot be maintained as it would thwart the very basis for protecting original works of intellectual property as codified in the United States copyright laws. It is simply incongruent to argue that the law imposes penalties for in-

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[47] *Larson*, 277 U.S. at 100.

[48] *Schnadig*, 620 F.2d at 1171.

fringing another's work while at the same time advocating that such an infringer should prosper from its violative behavior. The latter cannot be maintained either. As demonstrated by the above examples, infringer net gain is not a necessary evil of our system of copyright protection since the rule of non-deductibility prevents the infringer from deriving economic benefit.

b. The Interrelationship Between Non-Deductibility And Deductibility Create A Compound Effect

Although the rules of non-deductibility and deductibility are separate approaches that appear to be simply the inverse of each other, they are not. It is crucial to realize that the adoption of deductibility, and the simultaneous rejection of non-deductibility, creates a compounded result. For, the two are intertwined in such a fashion that the rejection of non-deduction has a negative impact while at the same time the allowance of a deduction has its own separate negative impact.

First, the allowance of a deduction from gross infringing profits permits a net gain to the infringer and deprives the original creator its full measure of damages. This situation not only prevents the equitable scenario of complete tax reimbursement to the infringer and complete payment of damages to the plaintiff, it allows the infringer to benefit through a net gain. Conversely, if non-deduction is adopted, the plaintiff receives the full measure of its damages and the infringer is reimbursed for all taxes paid, while at the same time the infringer is unable to profit from its illicit copying and the plaintiff is not deprived of any measure of its award.

Think of this double impact scenario as a swinging pendulum. Adopting one rule over the other does not place the pendulum in the middle, but swings it completely to one side or the other. Under such a scenario, then, it only makes sense that the rule swinging the pendulum to the side of complete infringer tax reimbursement and complete damage payment to the plaintiff should be favored over the rule that puts the pendulum into the situation of infringer gains and incomplete damage awards.

c. *The Examples Supporting Non-Deductibility Are Not Speculative*

In examining the hypotheticals discussed throughout this article, one true attack lies in the possibility that they are too speculative in their assumptions and are therefore an incomplete basis for adopting the rule of non-deductibility in all situations. More specifically, it can be argued as speculative that the infringer will actually take the deduction from gross income for damages paid, thereby preventing the scenario of infringer reimbursement.

This must be rejected on two general grounds. First, careful analysis removes any doubt or alleged speculation that may belie the rule because the rule creates its own incentive. Second, even if there remains any speculation, all doubt must be resolved in favor of the plaintiff whose work is protected through intellectual property law, not in favor of the infringer who has breached such protection.

(1) Lack of Speculation

The future deduction of an amount equal to any damages paid from the infringer's gross income is inherently unspeculative. First, as stated in *Schnadig*, because the infringer has several years to take advantage of the deduction of damages paid from gross income, the likelihood that such a deduction will be exploited is very high. Second, the rule of non-deductibility itself removes any speculation that the "after" deduction of damages paid will not be utilized in that it provides the infringer with a motive to take to the "after" deduction in order to protect its financial interests. Finally, the Supreme Court itself in *L.P. Larson, Jr., Co.* implicitly recognized that the "after" deduction from gross income was not speculative, but very certain. Each is treated in turn below.

(a) Infringers Have Ample Time to Take the Deduction

First, in *Schnadig*, the Sixth Circuit itself addressed the issue of speculation in terms of when, if ever, the infringer would be able to take the deduction. The Court presented the potential problem as follows:

Although the above illustration [referring to the infringer's potential to net as much as the copyright holder] is true in theory, the actual dollar impact of a damage award on the taxes of either party will naturally depend upon the party's overall tax situation. Tax rates will vary, and offsetting losses could conceivably bar use of the deduction or negate any tax effect of the award.[49]

In direct response to its self-created issue of "speculation," the court stated that "[n]onetheless, because a taxpayer can generally utilize a loss during any of the seven years after, or three years prior to the year the loss was incurred [citing I.R.C. § 172(b)(1)(B)], the vast majority of infringers should be able to utilize the deduction."[50]

(b) The Rule of Deductibility Creates Its Own Incentive

Second, what the Sixth Circuit failed to realize, or at least failed to articulate, is that the rule of non-deductibility itself removes any speculation that may appear to belie the adoption of the rule. When infringers pay or incur pre-tax profits, they face a situation of net loss because they have, in essence, paid the same income tax twice - first to the federal government and then to the copyright holder in the form of pre-tax profits. To avoid such a loss, infringers must seek a deduction from gross income in an amount equal to the damages paid, thereby reimbursing themselves for all taxes paid on the disgorged income and placing themselves in the position of zero gain and zero loss. Consequently, the rule itself creates the incentive for infringers to utilize the appropriate avenues of reimbursement by taking the appropriate after judgment (or settlement) deduction, nullifying any speculation that such a deduction would actually be taken.

If, however, the infringer is not inclined to take the appropriate deduction, or argue speculation based on the possibility that it may or may not take such a deduction, the infringer should, and will, bear the loss as the least cost avoider.[51] Since the plaintiff has no control over

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[49] *Id.* at 1169-70.

[50] *Id.* at 1170.

[51] The pharse "least cost avoider" refers to the party involved in a transaction that can avoid, or could have avoided, the loss or harm at issue in the most effecient and economical manner yet failed to do so.

an infringers' behavior, it is unable to force the infringer to seek recourse to the appropriate deduction, and cannot itself act to utilize the equitable result such a deduction creates. As a result, the infringer is the only entity that can utilize the deduction and protect its financial position, and should therefore bear any loss its inaction procures. This is certainly the fairest outcome, placing the loss on the infringer as the party that can act with the least effort to prevent the harm at issue.

In addition, an individual infringer's willful submission to loss through inaction cannot be considered a counter argument to the general rule of non-deductibility. Rather, the law must focus on the sensibilities of the average person, which certainly counsel in favor of exploiting the remedial avenue of preventing a net loss through a simple deduction from gross income. If there is any doubt as to what the sensibilities of the average person would counsel, the following question firms the answer: Would one rather pay more or less income tax? The answer is obviously "less." Therefore, an infringer that refuses to proactively protect its financial interests through recourse to the appropriate tax deduction must face the outcome of net loss that it has voluntarily elected.

Furthermore, when dealing with infringers whose income places them in the situation of rolling taxes, the tax reimbursement can actually be effectuated in real time. What this means to say is that if an infringer is paying taxes on a monthly or quarterly basis, it is also calculating its taxable income at the same intervals, taking the appropriate deductions from its taxable revenues. Since appropriate deductions are being made on such an ongoing basis, and damages paid in an infringement suit are appropriate deductions, the infringer can deduct the damage award almost instantaneously and realize a refund of the infringing tax liability in real time. There would be little lapse, if any, between the payment of the award and the return of infringing taxes, and no corresponding net loss during any given period

Therefore, *Schnadig*'s scenario of infringer reimbursement moves from speculative theory to operative reality through the operation of the rule and the incentive it creates.

(c) The Supreme Court Implicitly Recognized that There is No Speculation to the Rule of Deductibility

Finally, on the topic of speculation, *L.P. Larson, Jr., Co.*[52] itself implicitly recognized that an infringer's deduction of damages paid from gross income is not speculative. In that case, the Supreme Court stated, in relevant part:

> Even if the only relief that the [infringer] can get is *a deduction from gross income when the amount of its liability is finally determined*[,] the [plaintiff] will have to pay a tax on the . . . profits when it receives them, *and* in a case of what has been found to have been one of conscious and deliberate wrongdoing, we think it just that the *further deduction* [of income taxes] should not be allowed.[53]

With this, the Supreme Court references two separate deductions. The first is "a deduction from gross income when the amount of . . . liability is finally determined," and the second is a "further deduction." The reference to a deduction made from gross income when "liability is finally determined" is the deduction of damages-paid from gross income, and the "further deduction" is the deduction of taxes when calculating gross infringing profits. The latter deduction was of course the issue before the Court and the topic of this article.

The importance of the distinction between a "deduction" and a "further deduction" lies in the language used. By definition, a "further" deduction is taken only after, and in addition to, a primary deduction. In *Larson*, that "primary," first-taken deduction was the deduction from gross income for the amount of damages actually paid, or as the Court referenced it, "a deduction from gross income when the amount of its liability is finally determined."[54] If the "further" deduction, which was the issue before the Court, was concrete enough for the Court to adjudicate, the deduction taken before it must have been equally concrete in the Court's eyes.

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[52] This is the case upon which both the Sixth and Second Circuits rely, especially the Second Circuit where it states "It is settled law that the income tax paid on profits is not deductible where infringement was conscious and deliberate." *Design*, 13 F.3d at 566 (citing *Larson*, 277 U.S. 99).

[53] *Larson*, 277 U.S. at 100 (emphasis added).

[54] *Id.*

Therefore, the United States Supreme Court has implied that the deduction of damages paid from gross income, is not speculative.

(2) Any Doubt Must Be Resolved in Favor of the Copyright Holder

Even if uncertainty or speculation remains, after the above arguments have been preferred and examined, and it is still unclear whether the infringer will take advantage of the appropriate deduction from gross income, all such uncertainty or speculation should be resolved in favor of the lawful copyright holder.

This logic becomes more apparent when the "uncertainty" at issue is more closely examined and broken down to its true meaning. The "uncertainty" involved is essentially whether the infringer will take the appropriate after-judgment deduction or not and becomes nothing more than a situation where the infringer could benefit just as easily as the copyright holder could.

It would be inequitable to reach a position of this type of uncertainty, waiver between supporting the lawful copyright holder and the unlawful infringer, and resolve the conflict in favor of the unlawful infringer. The copyright laws are designed to protect the original author and his original works, not the parties and entities that infringe those works and profit unlawfully. Consequently, any rule of law that resolves to benefit the infringer in a situation that could just as easily result in benefiting the copyright holder is inherently contradictory to the very purpose of copyright law. Such an uncertainty must be resolved in favor of the lawful copyright holder.

(a) Accepted Accounting Principals Should Be Governed By Accepted Legal Principals When Calculating Damages In An Infringement Suit

Finally, in examining the applicability of *Schnadig*, accepted accounting principals and their relationship to the calculation of damages in a copyright infringement suit must be considered. Section 504(b) of the Copyright Act provides that the "infringer is required to prove his or her deductible expenses. . . ."[55] However, "[n]iether the Act nor

[55] Copyright Act §504(b).

the Committee Reports specify which expenses will be regarded as deductible costs."[56] Accordingly, Nimmer states that "[r]esolution must generally turn upon the definition of costs under accepted accounting practices."[57]

While Nimmer's assertion rings of common sense and may be true as a practical rule, accepted accounting practices ("AAP") must work as a product, and under the guidance, of accepted legal principles ("ALP") in infringement suits, fulfilling the goals of those principles and not working counter to them. To hold otherwise is tantamount to a finding that rules of law must bow before the practices of accounting, as if the rules of accounting were supreme to the rules of law in some constitutional or jurisprudential sense. This, of course, cannot be true.

In essence, then, the first question of the analysis surrounding an allowable deduction necessarily focuses on such a deduction as a matter of law. Specifically, it focuses on whether such a deduction is or is not legally proper. If such a deduction is found legally improper, no AAP can change that finding. Likewise, if the same deduction is found legally allowable, no AAP can work against that finding, but rather, must work in accordance with the rule of law. Of course, if there is no pronouncement of law on the deduction at issue, where it has not been deemed either proper or improper, AAP can certainly help to fill the void by guiding the courts as to what should or should not be proper, as Nimmer suggests.[58].

Therefore, implicit in Nimmer's assertion is the principal that AAP is necessarily the second step of the analysis, begging the larger legal question of whether or not the deduction is proper as a matter of law. Under no circumstances should AAP overrule a conclusion of law, or alter its application, unless the rule of law itself is predicated upon the application of AAP. AAP may certainly be considered by the courts in determining a proper legal finding, but they should be nothing more than advisory principles that give way to the logic and rationale of the law.

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[56] 4 Nimmer, § 14.03[B] (1997).

[57] *Id.*

[58] *Larson* at 100.

Consequently, as this article suggests, the logic and rationale of the law favor the non-deduction of taxes in calculating net profits, and no principle of accounting should overrule that conclusion.

D. *Close Examination of the Second Circuit's Opinion in* In Design *Reveals a Holding That Is Not Based on Sound Analysis*

Turning the focus from *Schnadig* and the policies supporting its legal conclusion, an examination of the Second Circuit's holding in *Design* is both instructional and necessary. A careful review of that opinion reveals an analysis that is inherently contradictory, that does not recognize fiscal realties, that does not directly address the Sixth Circuit's holding in *Schnadig*, that rejects the only case in its jurisdiction on point, and that bases its analysis on a contradictory jurisprudential history. Consequently, the flaws in the Second Circuit's opinion command its rejection if, for no other reason, than the court's analysis of the issue of deductibility is simply unpersuasive.

1. Reliance on Dicta

The Second Circuit begins its discussion of the issue of deductibility with the following statement: "It is settled law that the income tax paid on profits is not deductible where infringement was conscious and deliberate."[59] The court based this averment of law on *L.P. Larson Jr., Co.*, discussed supra, *Alfred Bell & Co. v. Catalda Fine Arts, Inc.*,[60] and *Sheldon v. Metro-Goldwyyn Pictures Corp.*,[61] differentiating the situations of deliberate and non-deliberate infringement. A summary and analysis of such discussion exposes its inherent contradiction, its reliance on dicta, and its failure to recognize the economic realities surrounding the issue.

Larson, as discussed above, dealt with a willful trademark infringement suit where the United States Supreme Court denied an allowance for income taxes paid in calculating net profits. In using that

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[59] *Design*, 13 F.3d at 566 (citing *Larson*, 277 U.S. 97 (1928); *Alfred Bell & Co. v. Catalda Fine Arts, Inc.*, 191 F.2d 99, 106 (2d Cir. 1951); *Sheldon v. Metro-Goldwyn Pictures Corp.*, 106 F.2d 45, 53 (2d Cir. 1939).

[60] *Alfred Bell*, 191 F.2d at 99.

[61] *Sheldon*, 106 F.2d at 45.

opinion, the Second Circuit relied upon the following language:

> Even if the only relief that the [infringer] can get is a deduction from gross income when the amount of its liability is finally determined[,] the [plaintiff] will have to pay a tax on the . . . profits when it receives them, and in a case of what has been found to have been one of conscious and deliberate wrongdoing, we think it just that the further deduction [of income taxes] should not be allowed.[62]

The final clause of the above quoted passage, "and in a case of what has been found to have been one of conscious and deliberate wrongdoing, we think it just that the further deduction [of income taxes] should not be allowed," was used by the Second Circuit to support the rule that non-deliberate infringers should be allowed the deduction.[63] Specifically, the Second Circuit stated that the Supreme Court "carefully limited the breadth of its holding recognizing that there could be cases where the circumstances of the infringer's conduct dictated that such a deduction would be proper."[64] While the holdings of our Supreme Court are powerful, the portion of the *Larson* opinion relied upon by the Second Circuit is only dicta with respect to the treatment of non-willful infringers since that case only addressed the issue of *willful* patent infringement.[65]

The next case discussed in *Design* is *Alfred Bell,*[66] where a trial court in the Southern District of New York interpreted *Larson* to find that a non-willful copyright infringer was entitled to a deduction of income taxes in calculating net profits.[67] On appeal, however, the Second Circuit "agreed with the district court's view of the law" on the issue of non-willful infringers, but it "rejected its finding of innocent infringement," finding that a deduction of income taxes was not proper in that case.[68] Consequently, the court's agreement, as a matter of law, that the deductibility of income taxes by non-willful infringers,

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[62] *Larson,*, 277 U.S. at 100.

[63] *See Design,* 13 F.3d at 566-67.

[64] *Id.* at 566.

[65] The supposed "caveat" of *Larson,* allowing deductibility in non-deliberate situations, is used by the Second Circuit in other willful infringement cases, which are discussed below. *See Design,* 13 F.3d at 566-67.

[66] 191 F.2d 99, 106 (2d Cir. 1951).

[67] *Design,* 13 F.3d at 566 (citing *Alfred Bell,* 86 F.Supp. at 418-19).

[68] *Id.*

was purely dicta. Nonetheless, it was cited by the court in *Design* to support its holding.

Next, the Second Circuit examined *Sheldon*,[69] another case from the Southern District of New York, where a non-willful plagiarist was allowed a credit for income taxes paid.[70] Again, on appeal, the Second Circuit recognized that under *Larson*, non-willful copyright infringers should be allowed a deduction for income taxes paid, but that the district court's finding of non-willful infringement was erroneous, and reversed on that ground.[71] As in *Alfred Bell*, the Second Circuit's pronouncement on the issue of non-deliberate infringers and allowable deductions from gross profits was dicta since the case before the court dealt with deliberate infringement only.

Consequently, the Second Circuit is incorrect in making its pronouncement that the rule of non-deductibility in cases of non-deliberate infringement is well settled. Quite the opposite, it is not settled at all, as illustrated by the fact that the court had to rely on dicta rather than any precedent, binding or otherwise. The Second Circuit makes the case against its own proclamation.

2. The Second Circuit Rejects the Hypothetical Tax Implications Supporting the Holding in *Schnadig* With No Analysis, But Rather, Relies On Precedent That Is Actually Contradictory to the Position of Non-Deductibility

Beyond addressing those cases that *Design* relies upon in announcing its "well decided" rule, this article now turns its attention to the Second Circuit's discussion of *Schnadig* and that case's analysis in adopting the blanket rule of non-deductibility. As the hypothetical tax arguments provided by the Sixth Circuit are the cornerstone of this article's thesis, the arguments levied against them must be addressed.

Obviously, the Second Circuit rejected the holding from *Schnadig*.[72] In so doing, however, the Second Circuit failed to provide any analysis on the invalidity of the Sixth Circuit's holding, or the im

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[69] 106 F.2d at 53.

[70] *Design*, 13 F.3d at 567 (citing *Sheldon*, 26 F.Supp. 134, 142 (S.D.N.Y. 1938)).

[71] *Id.* (citing *Sheldon*).

[72] *Design*, 13 F.3d at 567.

propriety of the logic supporting the Sixth Circuit's opinion. Rather, *Schnadig* was cursorily dismissed with the following language:

> Schnadig purports to illustrate hypothetically how an infringer in a patent infringement case who pays damages based on after-tax profits and takes an income tax deduction as allowed under Internal Revenue Code, 26 U.S.C. s 162 (1988 & Supp. III 1991), in the amount it paid to a patentee would, in the example the court uses, yield a net gain, leaving it in about the same position as the patent holder. (citation omitted). [¶] We think that when a claim is made for infringing profits, '[t]his means profits actually made. A book profit of a dollar is not a profit actually made when from the dollar the government takes twenty cents as the price for the right to make any profit at all.' *Macbeth-Evans Glass Co. v. L.E. Smith Glass Co.*, 23 F.2d 459, 463 (3d Cir. 1927). Hypothetical discussions of possible indirect tax ramifications do not change this basic fact.[73]

This conclusory rejection provides no analytical framework and fails to discuss any of the possible tax ramifications that are the very basis of *Schnadig*. The Second Circuit simply concluded that the hypothetical discussions of the Sixth Circuit did not change the definition of "profits actually made," adopting that phrase's definition from the Third Circuit's opinion in *Macbeth Evans*.[74]

This "analysis" is significant for two reasons. First, since the Sixth Circuit fails to provide a discussion supporting its rejection of *Schnadig* and the rule of non-deductibility, the validity of the Sixth Circuit's tax hypothetical remains essentially unchallenged, and should continue to marshal the same level of persuasiveness it did prior to the holding in *Design*. Second, in addressing *Schnadig* through recourse to the definition of "profits actually made" from the Third Circuit's opinion in *Macbeth Evans*, the Second Circuit actually contradicted its own analysis. For, *Macbeth Evans* is a case that stands for the very proposition recognized in *Schnadig* - an infringer will realize a benefit from the tax ramifications of deducting damages actually paid from gross income. The *Macbeth Evans* court actually framed its holding explicitly within such a recognition. Ironically, then, the Second Circuit, in its attempt to reject *Schnadig*, actually

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[73] *Design*, 13 F.3d at 567.

[74] *See Id.*

uses a case in support of it, thereby piercing its argument with its own analysis. The following careful examination of the Third Circuit's holding in *Macbeth Evans* reveals the Second Circuit's analytical flaw.

In *Macbeth Evans*, the defendant was found to have infringed the plaintiff's head lamp patent.[75] The trial court declined a deduction for income taxes in the calculation of net profits, and the Third Circuit reversed on appeal. Since the trial court made no calculation of what the after-tax profits were, the matter was remanded for such calculation. However, the Third Circuit also held that, in addition to making the appropriate findings of fact as to how much tax was actually paid on the infringing profits, the trial court was to "require the defendant, by bond in such amount as [the court] shall name and with such security as [the court] shall approve, to pay the plaintiff a like proportion of all moneys the government may refund to the defendant for taxes it has paid during the infringing period."[76] With its order on remand, then, the Third Circuit recognized that the infringer would be able to take a deduction from gross income in an amount equal to all damages paid, yielding a reduction in the infringer's tax liability. Or, as the Third Circuit phrased it, "all moneys the government may *refund* to the defendant for taxes it has paid during the infringing period."[77] Therefore, like the analysis under *Schnadig*, the *Macbeth Evans* court noted that the infringer would receive a refund for taxes paid on infringing income through the appropriate tax deduction.

Had the Second Circuit read the complete holding of the Third Circuit's opinion in *Macbeth Evans*, it would have noted that the Third Circuit implicitly supported the finding in *Schnadig* under the exact logic used by the Sixth Circuit in its opinion. The only difference between *Schnadig* and *Macbeth Evans* is that the former disallows the deduction completely, requiring the infringer to take the appropriate after judgment deduction from gross income to seek reimbursement, while the latter allows a deduction for taxes paid from gross infringing profits, but requires the infringer to post a bond from which the plaintiff will be paid an amount equal to the tax refund the infringer enjoys

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[75] This was a type of light bulb used in the headlights of a car.

[76] *Macbeth Evans Glass Co.*, 23 F.2d at 464.

[77] *Id.* (emphasis added).

by deducting its payment of damages from its gross income. Obviously, the Second Circuit only recognized the part of the *MacBeth Evans*' holding that disallowed the deduction, but did not recognize the portion of the holding that required a refund to the plaintiff. In essence, then, the Second Circuit failed to realize that *Schnadig* and *MacBeth Evans* represent two avenues that reach the same destination: the infringer must be disgorged of all benefit derived from its infringing behavior, including post judgment income tax benefits.

With its analysis, the Second Circuit merely removed the single quote from *Macbeth Evans* that "[a] book profit of a dollar is not a profit actually made when from the dollar the government takes twenty cents as the price for the right to make any profit at all."[78] Standing alone, this quote may help the Second Circuit's logic that a dollar figure of profits includes a deduction for taxes paid. However, in conjunction with the entirety of the Third Circuit's opinion, the statement is in opposite to the holding in *Design* and is meaningless as an attack on *Schnadig* and the rule of non-deductibility.

3. *Design* Relies on Contradictory Jurisprudential History, Thereby Weakening Its Holding

The next analytical flaw incorporated into the Second Circuit's opinion in *Design* is the reliance on a jurisprudential history that is contradictory to the position it espouses. A review of that history makes the point.

The matter of *Love v. Kwitny*[79] illustrates the contradictory jurisprudential history preceding, and relied upon by, *Design*. In *Love*, a case of non-willful copyright infringement, the trial court found that income taxes could not be deducted in calculating net profits under any infringement scenario.[80] In coming to that conclusion, the court stated that its position was strongly supported by *Schnadig* and its accompanying income tax hypotheticals.[81] The defendants in *Love*, on the other hand, argued that relevant authority in the Second Circuit

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[78] *Design*, 13 F.3d at 567.

[79] *Love v. Kwitny*, 772 F.Supp. 1367 (S.D.N.Y. 1991) *aff'd without opinion* 963 F.2d 1521 (2d Cir.) (1992).

[80] *Love*, 772 F.Supp. at 1372.

[81] *Id.* at 1371.

prevented the deduction of income taxes only in cases of willful infringement.[82] Specifically, the defendants relied on *Alfred Bell* and *Sheldon*, both of which are relied upon by the Second Circuit in *Design*, and discussed above.[83] The *Love* court rejected that authority, stating that "those cases did not deal directly with whether a non-willful infringer should be permitted to deduct from profits amounts paid as income taxes, but only whether a willful infringer should be allowed to do so."[84] The court went on to conclude that "[t]he suggestions in Sheldon and [Alfred Bell] that income taxes may be deducted by a non-willful infringer . . . is dictum."[85] The holding in *Love* was thereafter affirmed without opinion by the Second Circuit.[86]

When the Second Circuit was presented with the authority of *Love* during its disposition of *Design*, it dismissed the holding as non-binding on the basis that it was affirmed without opinion.[87] However, whether binding or not, the fact that *Love* was affirmed by the Second Circuit without opinion indicates a lack of confidence by that court in the authority of *Alfred Bell* and *Sheldon*, the basis for its opinion in *Design*.[88] For, if *Alfred Bell* and *Sheldon* had been as persuasive and decisive as the opinion in *Design* describes, *Love* would have been in complete contradiction to their holdings and certainly would have been summarily reversed. Obviously, since *Love* was not reversed, but affirmed, the jurisprudence which it distinguishes in its opinion, and which was heavily relied upon by the Second Circuit in *Design*, could only have been suggestive to the *Design* court, at best, and irrelevant at worst.

The net result is a contradictory jurisprudential history where the Second Circuit stated in dicta that non-willful infringers could deduct income taxes from gross profits, yet affirmed an order of a trial court holding that a non-willful infringer could not make such a deduction.

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[82] *Id.*

[83] *See Design*, 13 F.3d at 566.

[84] *Love*, 772 F.Supp at 1371.

[85] *Id.* at 1372.

[86] *Design*, 13 F.3d at 567.

[87] *Id.*

[88] *See, e.g.*., the dicta of *Alfred Bell* and *Sheldon* where the Second Circuit agreed with the district court's findings that non-willful infringers should be allowed deductions for taxes paid but ruled in both cases that there was willful infringement.

Design attempts to clear the confusion by defining dicta as authoritative law, and by dismissing *Love* as the non-binding lone wolf because it was affirmed without opinion. This jurisprudential development evidences the Second Circuit's lack of careful consideration of the issue, casting doubt on its casual dismissal of *Schnadig* and its "hypothetical" tax analysis, as well as its bottom line finding of deductibility for all infringers. Consequently, this lack of careful consideration warrants rejection of the *Design* holding it supports.

4. The Battle of "profit" Definitions Underscores the Weakness of the Second Circuit's Legal Reasoning.

The last leg supporting *Design* is the Second Circuit's definition of "profit." In its opinion, the court began with its own position of the law with respect to non-willful infringers, then moved through a discussion of its own jurisprudential dicta in *Sheldon* and *Alfred Bell*, and its dismissal of *Love*, and ended its analysis with its own view of the term "profit," relying on such definition to support its finding of deductibility. The reliance on such a definitional preference underscores the weakness of *Design*.

As cited above, the Second Circuit adopted the following definition of "profit" from the Third Circuit's opinion in *Macbeth Evans*:

> We think that when a claim is made for infringing profits, "[t]his means profits actually made. A book profit of a dollar is not a profit actually made when from the dollar the government takes twenty cents as the price for the right to make any profit at all." (Citation omitted.) Hypothetical discussions of possible indirect tax ramifications do not change this basic fact. . .(Citation omitted).[89]

In examining this aspect of *Design*'s decisional basis, recourse to *Love* again proves beneficial as that court presented an alternative definition of the term "profit," and its relationship to income taxes. In discussing the Second Circuit's classification of taxes as expenses in *Sheldon*, *Love* made the following observation:

> The fallacy . . . lies in [the] reference to taxes as "other expenses necessary to the business." Only in a vernacular sense are taxes "expenses." Federal income taxes are calculated by multiplying the tax rate by the "taxable income" - which itself is the difference between gross income

[89] *Design*, 13 F.3d at 567.

> and deductible expenses. (Citation omitted). In other words, income taxes are a function of income rather than an element of the expenses that one subtracts from gross revenues in order to calculate income.[90]

This is in obvious contradiction to the Second Circuit's chosen definition in *Design*.[91]

At first glance, then, uncovering the more correct definition would seem to guide a court to the proper rule on the issue of net profit deduction. However, the true analytical power of this definitional disparity lies in the fact that they are almost opposite in their meaning, as applied, yet equally true. Quite simply, this definitional difference illustrates the argumentative nature of each, and consequently, the argumentative nature of any holding based on each. Whether a court is to find one definition more preferable than the other, and the respective rule it supports, is guided by no more than individual preference and taste. Consequently, a decision of law based on the choice of one definition over the other underscores the weakness of relying on either as the basis for deciding that income taxes should or should not be deductible by non-willful infringers because, as the preference goes, so too does the rule of law. Therefore, since this definitional choice analysis was one of the foundational elements of the holding in *Design*, the Second Circuit's logic and reasoning must be questioned.

5. The Second Circuit's Analysis Undermines Its Authority on the Issue of Deductibility

Through this examination of *Design*, it becomes clear that the Second Circuit failed to provide any type of persuasive analysis for adopting its position. It relied almost entirely on dictum and its definitional preference of the term "profit" to support its legal finding, and simply rejected the well reasoned opinion of *Schnadig* out-of-hand without an analysis of the economic realities it presents. As such, the Second Circuit does not provide a well reasoned holding that should

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[90] *Love*, 772 F. Supp. at 1371-72.

[91] [W]e think that when a claim is made for infringing profits, '[t]his means profits actually made. A book profit of a dollar is not a profit actually made when from the dollar the government takes twenty cents as the price for the right to make any profit at all.

Design, 13 F.3d at 567.

be adopted in other circuits, but a conclusory statement of law that should not be followed.

III. CONCLUSION: THE RULE OF NON-DEDUCTIBILITY SHOULD BE APPLIED IN ALL CASES OF INFRINGEMENT

The rule of non-deductibility as announced by the Sixth Circuit in *Schnadig* should be adopted in all Circuits as it is the fairest and most well reasoned method of calculating net infringing profits in a copyright infringement suit. It is based on the economic realities, created by the Internal Revenue Code, that when deductibility is the rule an infringer is in a position of net gain, while when non-deductibility is the rule, an infringer gains nothing by way of his infringement and the copyright holder receives the full measure of its due profits. Further, the only obstacle that stands against the rule of non-deductibility articulated in the Second Circuit's opinion in *Design* is riddled with analytical shortcomings and contradictions, and inasmuch, creates support for the rule it attempts to reject.

Therefore, while it is analytically clear that non-deductibility should be the uniform rule throughout the federal judiciary, only time, and the United States Supreme Court, will tell.