

To Lynne

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PREFACE

The final product including any inaccuracies is, of course, the responsibility of the author.

Needless to mention, only the encouragement of my wife, Lynne, and my daughters, Julianne and Charlotte, and their gracious indulgence has made possible the completion of this work.

JON ERIC BISCHEL
Syracuse, New York
April 3, 1974

TAXATION

OF

PATENTS, TRADEMARKS, COPYRIGHTS, AND KNOW-HOW

by

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Preface

In recent years the importance of exploiting commercial and industrial intangible property—especially technology, trademarks, and copyrights—by licensing and other means has significantly increased. However, the federal tax burden often exercises a pervasive influence over the owner of a patent or similar property right in his choice of alternative exploitation methods. This book is intended to fill the need for a source of documented judgments concerning the federal income taxation of patents, trademarks, copyrights, and know-how which are not to be found in any other single authority. It is anticipated that such a comprehensive approach will be of valuable assistance to United States tax practitioners, patent and corporate attorneys, and others who deal with the structuring and tax planning for transfers of such property rights. The volume should also help foreign owners of intangle property to understand the operation of the United States international tax rules concerning exploitation of such property within the United States.

The text has been designed as a permanent reference—clearly explained and well-documented. The loose-leaf format will facilitate periodical modifications consistent with changes in applicable statutes, regulations, rulings, and commentaries, as well as timely additions and supplements of new developments. Since much writing is presently being done in the area, in particular with regard to foreign licensing, a bibliography of current writing is included at the end of the book for the reader who wishes to pursue topics at greater length.

I extend my sincere appreciation to my colleagues in the legal and accounting professions, and associates in the academic and business world who have generously contributed their time, assistance, and consideration. Particular thanks are extended to Alun G. Davies, Esq., Thomas A. Jenks, Esq., Richard S. Kahn, William G. McCollom, Esq., Richard C. Pugh, Esq., and Sidney I. Roberts, Esq., who made valuable suggestions throughout the progress of this work. I am also indebted to Craig J. Zicari (of the Syracuse University College of Law, class of 1974) for his invaluable research and editorial assistance.

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income from either domestic or foreign licensing operations are similar, such matters are covered in Part I. Considerations peculiar to foreign licensing income (e.g., the foreign tax credit, Subpart F provisions, and international taxation conventions) are dealt with in Part II.

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¶ 1.1 CAPITAL GAIN TREATMENT

Income derived from the licensing of intangible industrial and intellectual property rights is taxable at ordinary income rates unless it qualifies for capital gain treatment. Long-term capital gains, wherein the property has been held for more than six months prior to its sale or exchange, are given preferential treatment by virtue of a maximum tax rate of 25 to 35 percent on the gain. The noncorporate taxpayer is permitted to pay less than the maximum rate by deducting 50 percent of the gain and paying tax at the ordinary income rate on the remaining 50 percent of the gain.[4] Thus, from a tax liability viewpoint the attainment of capital gain status for licensing income is generally advantageous. Nevertheless, it should be kept in mind that a favorable income tax result is only one factor to be considered in ascertaining the optimum method for maximizing return from licensing operations. Often, capital gain status may be achieved only by sacrificing other desirable goals such as protection from nonexploitation, financial failure of the licensee, or the ability to fragment on a geographical or field-of-use basis. A thorough analysis must therefore be made on a case-by-case basis to balance the objectives of the licensor.

Historically, the availability of capital gain treatment for payments derived from the licensing of intangible property was governed by the general capital gain provisions of the Internal Revenue Code, Sections 1221 to 1223. Supplemental statutes were enacted, however, as tax incentives, to deal with complicated interpretive problems, and

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[4] Prior to the Tax Reform Act of 1969 the individual taxpayer was given an election of (1) removing one-half of his net long-term capital gains from income and paying tax on the remaining one-half at regular tax rates (in effect, causing the imposition of tax on the total amount of net long-term capital gain at one-half of the regular rate); or (2) paying an alternative tax rate of 25 percent on all net long-term capital gains. The alternative tax worked a benefit only if the taxpayer's marginal rate of tax exceeded 50 percent. See I.R.C. § 1201(b)(1)(2) (prior to the 1969 amendment). Since 1969, the 25 percent alternative tax rate continues to apply only to the first $50,000 of net long-term capital gain. The alternative tax rate for long-term gain exceeding $50,000 was raised in progressive steps being totally removed for taxable years beginning in 1972, thereby eliminating any alternative tax on net long-term capital gain exceeding $50,000. I.R.C. § 1201(c)(1).

The 50 percent deduction permitted by Section 1202 is unavailable to corporations. However, a corporation is permitted to employ the alternative tax rate. I.R.C. § 1201(a). Prior to 1970, and for any year beginning on or after April 1, 1954, the alternate rate of tax on net long-term capital gains was 25 percent. For taxable years beginning on or after January 1, 1970, and before January 1, 1975, the 25 percent rate is continued for amounts received due to contracts entered into, on or before October 9, 1969, and from liquidating distributions made by a corporation prior to October 10, 1970, if pursuant to a plan of com-

PART I.

THE DETERMINATION AND CHARACTERIZATION OF INCOME AND EXPENSES FROM LICENSING OPERATIONS

Introduction

The following material deals with the tax considerations encountered by persons engaged in the licensing of patents, industrial and commercial know-how, trademarks, trade names, and copyrights. In particular, the text emphasizes maximization of income tax benefits through:

(1) Receipt of capital gain income from disposition of such assets for
   (a) A lump sum received in one taxable year,[1] or
   (b) Installment payments spread over several taxable years.[2]

(2) Recovery of acquisition or development costs in
   (a) The current taxable year, or
   (b) Spread over several taxable years.[3]

United States citizens and residents are taxed on their worldwide income as determined under United States standards. However, since many tax considerations in determining and characterizing

---

[1] See I.R.C. §§ 1221–1223 (general rules for determining capital gain or loss); § 1235 (sale or exchange of patents); § 1231 (sale or exchange of depreciable property used in a trade or business); § 1253 (transfer of franchises, trademarks, and trade names). Citations are to the Internal Revenue Code of 1954 (I.R.C.) unless otherwise stated.

[2] See I.R.C. § 453(b) (installment method of reporting gain); §§ 1301–1305 (income averaging).

[3] See I.R.C. § 162 (trade or business expenses); § 174 (research and experimental expenses); § 167 (depreciation).

which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);"

[1] Patents. Unless a patent falls within one of the specific Section 1221 exclusions[7] it clearly qualifies as "property" for capital gain purposes.[8]

An inventor's property right in his invention does not come into being upon issuance of a patent. The property right arises when the original invention is reduced to actual practice, at which time the invention may qualify as property for capital gain purposes.[9] In some instances a contract to assign future inventions may qualify for capital gain treatment.[10] Also, it has been recognized that the transfer of a

[7] Most patents held by corporations do not qualify as capital assets under Section 1221 inasmuch as they are property used in a trade or business which is subject to depreciation. However, see discussion regarding qualification under Section 1231, ¶ 1.2c infra. Although the Internal Revenue Service has rarely argued that corporations are holding patents primarily for sale to customers, it has done so on a case-by-case basis in regard to individual inventors.

[8] See I.R.C. § 1221 as quoted in the text.

[9] M.P. Laurent, 34 T.C. 385 (1960), *government's appeal dism'd*, 5th Cir., 1961 P-H ¶ 56,406, *nonacq.* in 1961-2 C.B. 6; Edward C. Myers, note 5 *supra*. Note, it is not necessary that the assiguor have inviolate and confirmed patent rights to assign. Rather, it is sufficient consideration for the assignment that an inventor merely believed in good faith that he held patent rights to transfer. Rose Marie Reid, 26 T.C. 622 (1956); William R. Ost, T.C. Memo. 1958-18; Weller v. Brownell, 240 F. Supp. 201 (M.D. Pa. 1965).

[10] See Carl G. Dreymann, 11 T.C. 153 (1948). However, in general an agreement to assign all future inventions, unlimited as to subject matter and time, has been held to be invalid insofar as subsequent patents and inventions are concerned. See Ellis, *Patent Assignments* § 133 (3d ed. 1955); See also Guth v. Minnesota Mining & Mfg. Co., 72 F.2d 385 (7th Cir. 1934). In view of the

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Characterization of Income Under the General Capital Gain Rules

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been experienced in defining the categories of commercial and industrial know-how which will qualify as "property" for Section 1221 purposes.[18] As the term "know-how" has had a confused meaning, it is useful to isolate its principal components. By general usage, know-how encompasses a whole range of items which are the tangible products of man's ideas or skills. Among these are knowledge which may be placed in documentary or written form such as designs, plans, plant layouts, models, specifications, formulations, patterns, and processes. Other phases of know-how include developed policies in company administration, sales advertising techniques, and data on consumer acceptance. Finally know-how may consist of personal services required to implement the ideas on skills involved. To the extent that personal services are performed, know-how moves away from the concept of "property," which may create capital gain when transferred, and into the admitted realm of ordinary income.[19]

For tax purposes, the Supreme Court has approvingly cited the definition of property advanced by the Internal Revenue Service, i.e., either that property is the physical thing subject to ownership, or that it is the aggregate of the owner's rights to control or dispose of that thing (i.e., essentially anything and everything that is the subject of ownership).[20] Initially, under such a definition it would appear that all forms of proprietary know-how, in which the possessor may own something of value to a potential purchaser, should qualify as property for capital gain purposes.[21] For instance, the know-how

[18] Classification as a Section 1221 capital asset may often prove to be critical for purposes of deriving capital gain income from know-how licensing. The application of Section 1235 is restricted to patents. Further, since know-how does not have a determinable useful life (unless it is purchased for a specific term of years) it cannot by itself qualify for capital gain treatment as a Section 1231 asset. On the other hand, recent court rulings hold that where know-how transfers are incident to the transfer of patents, the know-how takes on the nature of the patents for purposes of determining whether it is Section 1221 or 1231 property for capital gain taxation purposes. See discussion ¶ 1.3b[1], *infra.*

[19] See discussion regarding "sale or exchange," ¶ 1.3, *infra.*

[20] Crane v. Comm'r, 331 U.S. 1 (1947); Citizens' State Bank v. Vidal, 114 F.2d 380 (10th Cir. 1940).

[21] Some foreign courts, which have also struggled with the question of proprietary know-how for taxation purposes, have held that knowledge which is communicable to others (for their own use) for value is property. See Comm'r v. United Aircraft Corp., 68 C.L.R. 525 (Australia 1943); BFH of 16 December 1970, BStBL 1971 II, p. 235 (Federal Republic of Germany). Additionally, commentators on this point have nniformly stated that know-how when expressed in documentary form (thus avoiding the vagaries of the law relating to intangibles) is property as that term is used in the Internal Revenue Code. See, e.g., Brainard, "Income from Licensing Patents Abroad," 38 Taxes 209, 229 (1960); Duffy, "Doing Business Abroad: Use of American Know-How,"

to thwart tax avoidance and undue tax benefits. The resultant present statutory scheme may be outlined as follows:

(1) Sections 1221 to 1223 determine in general what properties may be subject to capital gain treatment.

(2) Section 1231 extends capital gain treatment to the sale or exchange of intangible property used in a trade or business which is subject to depreciation.

(3) Section 1235 provides special capital gain rules for the sale or exchange of patents by individual inventors.

(4) Section 1253 restricts the availability of capital gain treatment on transfers or franchises, trademarks, and trade names.

(5) Sections 1239 and 1245 are limiting sections which give ordinary income treatment to gains which would otherwise be treated as capital gains.

Under the general capital gain rules, three requirements must be met to have long-term capital gain and loss benefits apply:

(1) There must be a capital asset (Sec. 1221) or property which is treated like a capital asset under Section 1231;

(2) There must be a sale or exchange of such property; and

(3) The property must be held a sufficient amount of time to qualify as a long-term capital gain.[5]

¶ 1.2 THE CAPITAL ASSET REQUIREMENT

¶ 1.2a Property Qualifying as a Capital Asset

The Section 1221 definition of property which qualifies as a capital asset is couched in negative terms as follows[6]:

"For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind

plete liquidation adopted on or before October 9, 1969. The remainder of the net long-term capital gain is taxed at a 30 percent rate for taxable years beginning in 1971. After 1975 the entire net long-term capital gain will be taxed at the rate of 30 percent. See generally I.R.C. § 1201(a)(1) and (2).

[5] For an analysis of the three requirements in the context of patent licensing income, see Edward C. Myers, 68 U.S.P.Q. 346, 6 T.C. 258, 262 (1946).

[6] Two further exceptions in Section 1221 which are not applicable to licensing have been omitted.

poration. Such payments should therefore be allocated between the license to use the 'know-how' and the personal services. Since the personal services have a nominal value apart from the license to use such 'know-how' but a nominal sum should be allocated to the licensee."

The second Service pronouncement concerning the matter occurred in 1964.[23] In a radical departure from its prior position, the Service in ruling on the narrow issue of whether know-how constituted property which could be transferred tax-free in exchange for stock or securities under Section 351, held that property (and thus for tax purposes the term "know-how" as well) extends only to secret processes and formulas:

"Since the term 'know-how' does not appear in section 351 of the Code, its meaning is immaterial in applying this section, and the Service will look behind the term in each case to determine to what extent, if any, the items so called constitute 'property . . . transferred to a corporation . . . in exchange for stock.'

"The term 'property' for purposes of section 351 of the Code will be held to include anything qualifying as 'secret processes and formulas' within the meaning of sections 861(a)(4) and 862(a)(4) of the Code and any other secret information as to a device, process, etc., in the general nature of a patentable invention without regard to whether a patent has been applied for (see G.C.M. 21507, C.B. 1939-2, 198; *Wall Products Inc. v. Commissioner*, 11 T.C. 51, at 57 (1948), acquiescence, C.B. 1949-1, 4; *Ralph L. Evans v. Commissioner.* 8 B.T.A. 543 (1927)), and without regard to whether it is patentable in the patent law sense (see *Marvin R. Thompson v. Johnson,* United States District Court for the Southern District of New York, entered July 26, 1950, 50-2, U.S. Tax Cases, paragraph 9428, 42 American Federal Tax Reports 1284). Other information which is secret will be given consideration as 'property' on a case-by-case basis.

"The fact that information is recorded on paper or some other physical material is not itself an indication that the information is property. See, for example, *Harold L. Regenstein, et ux. v. Commissioner*, 35 T.C. 183 (1960), where the fact that a program for providing group life insurance to Federal Government employees was transmitted in the form of a written plan did not preclude a finding that the payment for the plan was a payment for personal services.

". . . .

[23] Rev. Rul. 64-56, 1964-1 C.B. 133.

patent with a provision for the transfer of improvements thereon is subject to capital gain treatment.[11] Therefore, it logically follows that payments to an assignee for use of an unexpired improvement patent under an agreement which grants substantial rights in an invention covered by the patent and future improvements thereon constitutes capital gain even though the only assignment of the improvement patent is in the original patent and the original patent has expired.[12]

[2] Trademarks. The Commissioner has conceded the status of a trademark as property for taxation purposes.[13] As trademarks are generally not depreciable[14] they fit within the definition of a capital asset unless specifically excluded under the facts of a particular situation.[15] Further, like a patent, the property right in a trademark arises when the trademark is reduced to actual practice, which in some instances is prior to its registration.[16] Hence, the trademark may be the subject of a sale at that time.

[3] Know-how. In many licensing agreements, wholly apart from the presence of patents, know-how constitutes the bulk of the consideration furnished by the licensor.[17] A great deal of difficulty has

invalidity of such an agreement to effect a sale, amounts received pursuant to it must necessarily be considered ordinary income. Julian A. McDermott, 41 T.C. 50 (1963). On the other hand, a contract to sell future inventions which is limited in scope is valid and therefore may constitute property for income taxation purposes. For instance, Convey v. White, 9 F.2d 863 (2d Cir. 1925), quoted in the *Dreymann* case *supra*, involved an agreement contained in an employment contract to contract to transfer to the employer "all inventions and discoveries made by" the employee "during the term of his employment, which in any way may affect any articles manufactured by" the employer. The court stated: "It [the contract] was not an agreement to assign in gross the defendant's future labor as an inventor, but only the inventions and discoveries made during the term of his employment, and which in any way might affect the articles manufactured by the company, and which were used or capable of being used in the business."

[11] Heil Co., 38 T.C. 989, 1002 (1962).

[12] Thomas L. Farwick, 52 T.C. 104, 113 (1969).

[13] Rev. Rul. 55-694, 1955 C.B. 299.

[14] Reg. § 1.167(a)-3. Trademark expenditures may, of course, be amortized under Section 177. See discussion ¶ 5.4 *infra*.

[15] For instance, a trademark would be disqualified from capital asset status if it were held primarily for sale to customers in the ordinary course of trade or business. See, e.g., Harold T. Avery, 47 B.T.A. 538 (1942); cf. Joseph A. Fields, 14 T.C. 1202 (1950), *aff'd* 189 F.2d 950 (2d Cir. 1951).

[16] See, e.g., Edward C. Myers, 6 T.C. 258 (1946); Carl G. Dreymann, 11 T.C. 153 (1948).

[17] This is particularly true of licensing agreements entered into between American licensors and foreign licensees.

well as all the patent rights for two- and four-wheel tractors, scrapers, and wagons. The Service took the position that although the transferred patents may have been capital assets, the engineering and manufacturing know-how was not such an asset. This position had the effect of classifying know-how as services rendered. The court disagreed, finding that since the know-how was pertinent and necessary to the successful manufacture of the products under the patents, it was an incident of the patents, took the same nature of such property, and thus constituted a capital asset, i.e., property that also was sold.[28] In essence, however, the reasoning of the court seems to beg the answer to the question of whether nonconfidential know-how is property for capital gain purposes. It would be an unusual transfer of nonconfidential know-how which would not be coupled with a transfer of patents or trade secrets and be pertinent to their successful utilization.

In spite of an adverse decision and acquiescence of the *Heil Co.* decision, the Service continued to maintain its know-how position in *United States Mineral Products Co.*[29] and *PPG Industries, Inc.*[30] However, the Tax Court consistently ruled that know-how (information) incident to patent transfers assumes their nature and thus qualifies as property. Further, in *United States Mineral Products* the court indicated that a formula whose secrecy had been partially breached would not necessarily be disqualified as property for capital gain purposes.[31] In the most recent Tax Court litigation regarding know-how, *Taylor-Winfield Corp.*,[32] the Service failed to even make the argument that nonsecret manufacturing know-how does not constitute property for capital gain purposes. The court's opinion stated:

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and notes on manufacturing operations, and shop practices and performance times.

[28] Heil Co., note 26 at 1003, *supra.*

[29] 52 T.C. 177, 199, (1969), *acq.* 1969-2 C.B. 25. The court ruled in the taxpayer's favor even though the connection between the nonconfidential know-how and transferred patents appeared quite tenuous.

[30] 1970 P-H T.C. Memo. ¶ 70,354. The only case in which the government conceded the *Heil Co.*, note 26 *supra,* approach to know-how was Bell Intercontinental Corp. v. United States, 381 F.2d 1004 (Ct. Cl. 1967), argued by the U.S. Department of Justice, Tax Refund Litigation Division.

[31] The court pointed out that in other contexts, it has been held that the term "property" within the tax laws should not be given a narrow or technical meaning. United States Mineral Prods. Co., note 29 *supra* at 198.
stockholder. 10-42 Corp., 55 T.C. 593 (1971), *nonacq.* 1972 P-H T.C. Mem.

[32] 57 T.C. 205 (1971). Appealed by the taxpayer on other grounds to the Sixth Circuit, March 17, 1972. Also see Cubic Corp. v. United States, 28 A.F.T.R. 2d 71-6105.

may consist of a process known only by a few competitors in a large industry. Another example of valuable information might consist of a complete package of documents disclosing a highly technical although commonly known process in the industry. The reduced cost of acquiring this information in mass, rather than piecemeal, could prove to be a substantial savings, and thus of value to a potential purchaser. Finally, the possibility always exists that what is considered common knowledge at one place may be considered a revelation at another.

United States tax officials have encountered difficulty in defining the outer limits of proprietary know-how. The fluctuating positions adopted by the Internal Revenue Service concerning its criteria are found in Revenue Rulings published during the past two decades. In general, the Service has adopted the view that only the trade secret elements of know-how are property.

The first know-how ruling, Revenue Ruling 55-17[22] involved a nonresident corporation, not engaged in a trade or business in the United States, which possessed know-how in the form of techniques and methods for the recovery and purification of certain chemicals. A domestic corporation desiring to utilize the know-how in the United States entered into a licensing agreement providing for the payment to the foreign corporation of certain installments based on production. It was determined that the payments applicable to the know-how rights conveyed to the domestic corporation were in the nature of royalty income, hence subject to withholding tax. The Service, therefore, conceded that the nonservice element of know-how is a type of property subject to recognition under the Internal Revenue Code. The Service states:

> "While manufacturing 'know-how' is of a nonpatentable nature, it is something that its possessor can grant to another for a consideration. The right to use such 'know-how' is not materially different from the right to use trademarks, secret processes and formulas, and, if the right thereto is granted as part of a licensing agreement, it becomes, in effect, an integral part of the bundle of rights acquired under such agreement.
>
> "The payments made under the contract are applicable both to the specific rights therein granted, i.e., the right to use the 'know-how', and to services performed abroad in instructing and training the employees or technicians of the domestic cor-

N.Y.U. 20th Inst. on Fed. Tax. 1269, 1271–1272 (1962); Bischel, "Exportation of American Technology and the Federal Income Tax. Part I: Direct Transfers," 22 Syracuse L. Rev. 867, 877–878 (1971).

[22] 1955-1 C.B. 388.

including the rights to make, use, and sell (i.e., disclose to third parties).[36]

¶ 1.2b Exclusions

[1] Stock in Trade. Under Section 1221(1), a patent, trademark, or know-how is not a capital asset if it consists of "stock in trade . . . or property held . . . primarily for sale to customers in the ordinary course of [the taxpayer's] trade or business." A sale of such property gives rise to ordinary income.

In the case of patents, prior to enactment of Section 1235 in 1954, the tax consequences of a sale by an individual turned in part on whether the inventor was a professional who held patents for sale to customers or an amateur who held the patents as a capital asset. An overwhelming percentage of the judicial authority on the matter favored the taxpayer. Courts were reluctant to find professional status unless the business at hand was devoted directly and on a continuous basis to developing and selling patents as stock in trade.[37] For instance, in *First National Bank of Princeton v. United States* [38] the taxpayer was an active inventor in optics and acoustics, having obtained nineteen patents in those fields. He had sold twelve of these patents to a partially owned corporation. The patent in question pertained to toothbrush bristles, and was the only one which ever proved commercially profitable. The court stated:

"If Prof. Cooke was in the business of making and selling optical and acoustical inventions . . . he was completely an amateur inventor insofar as the toothbrush patents were concerned. To hold otherwise would be to aggrandize conditions under which the property must be held for sale in the ordinary course of trade

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[36] See discussion ¶ 1.3b[1] *infra*.

[37] Taxpayers were found to be professional inventors in Harold T. Avery, 47 B.T.A. 538 (1942); Harvey v. Comm'r, 171 F.2d 952 (9th Cir. 1949); and Paul H. Smythe, Jr., CCH Dec. 12,576-C, B.T.A. Memo. (1942). By contrast, in Dairy Queen of Okla., Inc., 18 T.C.M. 322 (1959), a corporation entered into thirty-six licenses in two years, each conveying the right to manufacture and distribute Dairy Queen in Oklahoma. The court found the corporation was not in the business of selling franchises; the unsold territory was not the corporation's stock-in-trade, and the franchise was not held by the taxpayer for sale to customers in the ordinary course of its trade or business.

[38] 136 F. Supp. 818 (D.N.J. 1955). See also Rose Marie Reid, 26 T.C. 622 (1956); Pike v. United States, 101 F. Supp. 100 (D. Conn. 1951); Carl G. Freymann, 11 T.C. 153 (1948); Harris v. Comm'r, 143 F.2d 279 (2d Cir. 1944); Herwig v. United States, 105 F. Supp. 384 (Ct. Cl. 1952).

"Revenue Ruling 55-17, C.B. 1955-1, 388, is modified to remove the implication that payments for the rights described there as 'know-how' will be treated as royalty income without regard to the factors applied here to determine whether such rights constitute property."

The most recent Internal Revenue Service statement regarding know-how is Revenue Procedure 69-19.[24] There, the Service expressly reiterated its view that only the trade secret portion of know-how qualifies as property. The primary purpose of the ruling was to set forth the conditions or circumstances under which the Service will issue advance Section 367 rulings for the transfer of know-how to controlled foreign corporations:

"In order for a secret process, formula, or other secret information (often referred to as technical 'know-how,' and hereinafter referred to simply as 'information') to qualify as property that can be transferred, without recognition of gain or loss, in exchange for stock or securities under section 351 of the Code, Revenue Ruling 64-56, C.B. 1964-1 (Part I), 133, provides in part that (1) the consideration from the transferor (the 'information') must actually qualify as property within the meaning of sections 861(a)(4) and 862(a)(4) of the Code rather than personal services in the form of technical assistance and (2) the country in which the transferee is to operate must afford to the transferor substantial legal protection against the unauthorized disclosure and use of the 'information.'"[25]

In litigation the Service has maintained the same position taken in its recent know-how rulings. Actually, the Service's current stance on know-how first became apparent two years before Revenue Ruling 64-56 in *Heil Co. v. Comm'r.*[26] In *Heil Co.* the taxpayer-licensor transferred engineering and manufacturing know-how[27] as

[24] 1969-2 C.B. 301, 302.

[25] The insistence of the Commissioner that only secret information will qualify as property raises a rather interesting evidentiary question. Will the Commissioner assume the burden of establishing that the taxpayer's information was not secret or will the taxpayer be expected to undertake the more imposing task of proving that it is secret? Obviously, the Commissioner is concerned with a broader policy question – for tax purposes under what circumstances may personal efforts be converted into capital assets qualifying for potential capital gain rather than ordinary income treatment upon disposition?

[26] 38 T.C. 989 (1962), *acq.* 1963-1 C.B. 4.

[27] The engineering and manufacturing know-how transferred by *Heil* consisted of commercial and technical data for manufacture of the items, all general and detailed engineering drawings, drawings of jigs and fixtures and of special tools, specifications of materials and heat treatment, engineering lists

payer's business should be characterized as ordinary income or loss. The Court stated that this was the proper characterization even though the property did not literally come within the inventory or other statutory exclusions to the definition of a capital asset. It rationalized that it was not Congress's intent to provide preferential capital gains treatment for everyday business operations.[44]

[3] Copyrights. As Section 1221(3) indicates, the United States discriminates against artistic innovations by generally excluding copyrights and "similar property" from capital asset classification.[45] The phrase "similar property" includes property eligible for statutory or common law copyright protection, such as theatrical productions, radio programs, and newspaper cartoon strips.[46] Further, the courts have ruled that "similar property" extends to any artistic work which is the product of personal efforts regardless of whether it is copyrightable. In *Crawford v. United States*,[47] the court determined that a noncopyrightable format for a radio quiz program was similar property; and in *Stern v. United States*[48] the court held a literary concept, even if not copyrightable, to be similar property.

A copyright may qualify as a capital asset in the hands of a person

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[44] *Id.* at 47.

[45] This distinction originated with the Revenue Act of 1950, 64 Stat. 933 (1950), which removed copyrights from the definition of a capital asset. Before 1950, transfers of patents and copyrights were treated substantially the same for purposes of capital gain taxation. See Casey, "Sale of Patents, Copyrights, and Royalty Interests," N.Y.U. 7th Inst. on Fed. Tax. 383, 384–91 (1949). Note, however, as copyrights and literary rights are considered "property" for taxation purposes such rights may be transferred thus, avoiding income assignment problems as well as fostering tax postponement opportunities. See Hoffman, "Tax Planning for Authors," 46 Taxes 430 (1968). See also discussion ¶ 3.1a *infra*.

[46] Reg. § 1.1221-1(c). Note, however, some ideas may be severable into patentable and copyrightable segments. Under such circumstances, the Internal Revenue Service has conceded capital gain characterization for that portion of the royalty payment attributable to the patentable segment, even though a patent application has not been filed. See Davis, II Practical Patent Licensing (1969).

[47] 338 F.2d 379 (Ct. Cl. 1964). See also Mildred Kennedy, T.C. Memo. 1965-228; Jackson Hill, 47 T.C. 613 (1967); Arthur Kurlow, T.C. Memo. 1963-282, *aff'd* 343 F.2d 625 (2d Cir. 1965). But see Jose v. Kerrer, 35 T.C. 617 (1961), *rev'd* 304 F.2d 125 (2d Cir. 1962), where the circuit court ruled that a professional actor derived capital gain upon the sale of a domestic production contract to the extent the proceeds were allocable to his surrender of a "lease" granted to him by the author of a novel for a stage play production based upon the novel.

[48] 164 F. Supp. 847 (E.D. La. 1958), *aff'd per curiam* 262 F.2d 957 (5th Cir. 1959).

> "The taxation of transfers for consideration of technical data, secret processes, and trade secrets is a subject not specifically covered by statute or regulation. It is settled, however, that unpatented technology such as know-how can be the subject of a sale and that technical data is treated for tax purposes in a manner similar to patents. Sec. 1253(a), I.R.C. 1954." [33]

Although the above statement would appear to increase the likelihood of capital gain treatment for all sales of nonsecret manufacturing know-how, its weight is diminished by a lack of significant nonsecret know-how in the case's factual pattern. Thus, the court may have tacitly considered the nonsecret know-how to be incidental to the transferred patents or trade secrets.[34]

To minimize potential taxation at ordinary income rates from know-how reclassification, the following points should be considered:

(1) The only type of know-how specifically recognized as property for capital gain purposes is secret information in the general nature of a patentable invention. Many licensing agreements contain a provision which indicates that the transferred know-how is regarded as confidential information between the parties.[35]

(2) Consideration paid for the transfer of nonconfidential manufacturing know-how or operational know-how (services) qualifies for capital gain treatment if it is "incidental" or "ancillary" to a qualifying transfer of patents or trade secrets. Therefore, a licensing agreement should recite that nonconfidential know-how is to be employed in implementing the transferred patents or trade secrets.

(3) If nonconfidential know-how is more than incidental or ancillary to the transfer of qualifying property the consideration should be allocated between the qualifying property, nonconfidential know-how, and services performed, if any.

(4) Even if the know-how transferred qualifies as property for capital gain purposes, capital gain treatment is available only if the transfer is of all substantial rights to the know-how

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[33] Taylor Winfield Corp. v. Comm'r, note 32 *supra*.

[34] Alternatively, the Service may have had no need for the know-how property argument in view of its successfully maintaining that all substantial rights to the know-how had not been transferred.

[35] Recently, the Internal Revenue Service permitted more latitude to taxpayers regarding proof of what information is confidential or exclusive, especially where foreign law is concerned.

ness of producing and selling patents. To date, the issue has been raised in only one case involving domestic sales of patents, *Allied Chemical Corp. v. United States.*[55] In this case the taxpayer developed numerous patents in connection with its own operations. However, the sale of a patent was considered so unusual that it required consultation of the corporation's top management. The court found no occurrence of a sale to customers in the ordinary course of business where Allied's regular day-to-day affairs did not concern the sale of patents.[56] Further, the court stated that isolated sales of patents are not in the ordinary course of business where only a small percentage of the taxpayer's income has a source in patent royalties. The result confirms the view that sales by corporate patent holders would seldom be excluded from Section 1231 treatment since corporate research efforts are devoted primarily to the development of patentable products rather than the development of salable patents.

The Internal Revenue Service has similarly ruled that the Section 1231 exclusion relating to copyrights does not apply to a publicly held corporation producing motion pictures where the individuals whose efforts produced the film were adequately compensated and were not stockholders.[57] By contrast, films or plays produced by a closely held corporation or partnership through the efforts of its shareholders or partners would not qualify as Section 1231 assets.[58]

The disposition of foreign patents and qualifying copyrights may, however, raise additional considerations. For instance, if domestic and foreign patent rights are considered as separable property for the purpose of sale, they could also be considered separate and distinct in determining whether these rights are held primarily for sale. Unquestionably, a foreign patent grant adds value to the underlying invention, as does each succeeding foreign patent of the same invention. If foreign patents are separable, can domestic usage in a

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[55] 17 A.F.T.R.2d 316, (D.C.N.Y. 1966), *aff'd* 370 F.2d 697 (2d Cir. 1967).

[56] However, it should be noted that the *Corn Products* doctrine has been held applicable to Section 1231 transactions. Hollywood Baseball Ass'n v. Comm'r, 423 F.2d 494 (9th Cir. 1970). See also United States v. Haas, 341 F.2d 444 (10th Cir. 1965), dictim that *Corn Products* case can apply to Section 1231 assets. The significance of *Hollywood Baseball* for patent and copyright transferors may ultimately lie in the approach to such problems taken by the Tax Court – one which does not favor taxpayers with a history of sales of any type of property for which capital gain is claimed. See Hollywood Baseball Ass'n, 49 T.C. 338 (1968).

[57] Rev. Rul. 55-706, 1955-2 C.B. 300, superseded on another ground by Rev. Rul. 62-141, 1962-2 C.B. 182. See also Desilu Prods., Inc., 24 T.C.M. 1695 (1965).

[58] See Ernest H. Martin, 50 T.C. 34 (1968).

or business in order to remove it from the capital asset category." [39]

Thus, it was insufficient that Professor Cooke be regarded as an inventor to qualify the toothbrush patents as stock in trade, but rather that his business must necessarily be in that precise field of industry.

Since the introduction of Section 1235 in 1954 the distinction between amateur and professional inventors for Section 1221 purposes is no longer of much importance to individual inventors and other "holders" of patents.[40] Nevertheless, the amateur and professional distinction is still of concern to (1) the individual developer of know-how, (2) the purchaser or beneficiary of copyright licenses, and (3) possibly the corporate patent licensor.

[2] Property "Held Primarily for Sale." Intellectual property will not, according to Section 1221, qualify as a "capital asset" if the property is held "primarily" for sale to customers in the ordinary course of trade or business. The Supreme Court in *Malat v. Riddell* [41] has recently construed the term "primarily" as used in Section 1221(1) to mean of "first importance" or "principally." Thus, a "substantial" sales purpose is not sufficient to disqualify sales of property from capital gain status. On a practical basis *Malat* has had little discernible effect on the decisions of lower courts, since it provides no insight into the meaning of the important term "ordinary course of [the taxpayer's] trade or business".[42]

In the *Corn Products* case [43] the Supreme Court held that gain or loss from the sale of property which is an integral part of the tax-

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[39] First Nat'l Bank v. United States, note 38 *supra.*

[40] The question of whether a "holder" (as defined for purposes of Section 1235) may employ either the Section 1221 or 1231 routes to capital gain where a particular transaction fails to meet all of the Section 1235 tests is as yet unresolved. See discussion ¶ 2.6b *infra.*

[41] 383 U.S. 569 (1966). See also Corn Prods. Refining Co. v. Comm'r, 350 U.S. 46 (1955). Although the *Malat* case involved a dual purpose (investment or sale) at the time the property was acquired, Scheuber v. Comm'r, 371 F.2d 996 (7th Cir. 1967), holds that the principles of *Malat* are equally applicable where property is acquired with the single purpose of selling it sometime in the future.

[42] For a discussion of the term for Section 1231 purposes, see ¶ 1.2c[1] *infra.*

[43] Corn Prods. Refining Co. v. Comm'r, 350 U.S. 46 (1955). See also Continental Can Co. v. United States, 400 U.S. 819 (1970). In practice, the *Corn Products* doctrine is of little consequence where intellectual property is involved since it would be an unusual business which buys and sells patents, trademarks, know-how, or copyrights in its everyday business operations.

they are not depreciable property and therefore do not fall within the statutory exclusion. They are not subject to depreciation because by their nature they are deemed to have an indefinite or perpetual life which precludes amortization of their cost over their useful life.[62] In this respect they differ from patents and copyrights and are thus deemed capital assets under Section 1221, rather than depreciable assets used in a trade or business under Section 1231.

The same is true regarding gain from the sale of unpatented inventions, even though a patent application is planned or has been submitted to the Patent Office. Until a patent actually issues, the useful life of the invention is indefinite and therefore nondepreciable.

[3] Computation of Section 1231 Net Gain or Loss. The Regulations set forth the following steps for determination of net gain or loss from Section 1231 transactions:

(1) Compute the gain or loss on the sale of each item of Section 1231 property;
(2) Total all gains;
(3) Total all losses;
(4) Net the total gain against the total loss;
(5) If the result is a net gain, it is treated as long-term capital gain;
(6) If the result is a net loss, it is treated as ordinary loss.[63]

The taxpayer may not treat the sale of each Section 1231 asset separately and take ordinary loss upon the total losses and a capital gain upon the net gains. Total losses and gains must be netted and the net gain or loss treated accordingly.

¶ 1.3 THE SALE OR EXCHANGE REQUIREMENT

¶ 1.3a Sale vs. License

Intangible property such as patents, trademarks, copyrights, and know-how may be exploited either by complete divestiture of ownership through an assignment by sale or exchange, or merely permitting its use through a license agreement in the nature of a lease. While a sale or exchange may result in capital gain treatment, a

[62] See discussion regarding depreciation, ¶ 1.5a *infra.*

[63] Reg. § 1.1231-1(a).

who is neither the creator of the property nor his donee. The Section 1221(3) capital asset exclusion is not applicable to a copyright owner such as a purchaser or legatee whose basis is not determined, in whole or in part, by reference to the creator's basis.[49]

¶ 1.2c Property Held for Use in Trade or Business and Section 1231

Patents and copyrights, if employed in business (in particular when employed by most corporations) do not qualify as capital assets under Section 1221. The specific categories of property excluded from the term "capital asset" by definition includes "property, used in [the taxpayer's] trade or business, of a character which is subject to an allowance for depreciation. . . ."[50] Patents and copyrights are cited as specific examples of intangible property subject to an allowance for depreciation in the Regulations under Section 167.[51] Therefore, patents and copyrights held by most individual and corporate businesses fail to qualify as capital assets.

Property so held, however, usually does qualify for capital gain treatment under Section 1231.[52] Section 1231 provides for capital gain treatment on the sale or exchange of depreciable property used in trade or business which is held for more than six months,[53] provided the property is not held by the taxpayer primarily for sale in the ordinary course of business.[54]

[1] The "Held Primarily for Sale" Exclusion Under Section 1231. While parallels exist between the Sections 1221 and 1231 "held primarily for sale in the ordinary course of . . . business" exclusions, there are important practical differences. For instance, in viewing the sale of patents used by a corporation in its domestic trade or business, the argument that any individual patent or group of patents was held primarily for sale would be difficult to sustain in as much as corporations are rarely substantially involved in the busi-

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[49] I.R.C. § 1221(3)(C).

[50] I.R.C. § 1221(2).

[51] Reg. § 1.167(a)-3.

[52] See, e.g., Carl G. Dreymann, 11 T.C. 153 (1948); Edward C. Myers, 6 T.C. 258 (1946) (patents). A sale of copyrights may also qualify for Section 1231 capital gain treatment if it is not held by the author or his donee. § 1231(b)(1)(C). See also Rev. Rul. 55-706, 1955-2 C.B. 300 (copyrighted motion picture films).

[53] I.R.C. § 1231.

[54] I.R.C. § 1231(b)(1)(B).

erally made to depend on the degree to which the substantial rights in the invention have been transferred.

The issue of whether all substantial rights have been transferred arises only when the transferor has retained rights of some sort. The substantiality of retained rights has, therefore, become the major factor employed by the courts in determining whether all substantial rights to the invention have been transferred. Substantial rights, if retained by the transferor preclude qualification of the transfer as a sale for taxation purposes. Yet, many rights a transferor may wish to retain have been held to be insubstantial when viewed individually. Retained rights may be considered on a cumulative basis, however, in determining whether all the rights retained by the transferor collectively effect the retention of substantial rights under the terms of a particular licensing agreement.[67]

Right to manufacture, use, and sell the patented article. In the past, to effect the sale of a patent, a transfer had to include the exclusive right to make, use, and sell the patented invention for the full unexpired term of the patent.[68] Capital gain treatment was pre-

sideration, the total rights of one possessor of a patent are transferred irrevocably and forever to another falls squarely within the meaning of the term "sales" as used for tax purposes in Sections 1222 and 1231(a) originated in Parke, Davis & Co., note 69 *infra*. See also Edward C. Myers, 6 T.C. 258 (1948); Allen v. Werner, 190 F.2d 840 (5th Cir. 1951); Lawrence v. United States, 297 F.2d 466 (5th Cir. 1961); Bell Int'l Corp. v. United States, 381 F.2d 1004 (Ct. Cl. 1967); Allied Chem. Corp. v. United States, 370 F.2d 697 (2d Cir. 1967).

[67] See discussion accompanying notes 103 to 112, *infra*.

[68] The "make, sell and use" criteria originated with Waterman v. MacKenzie, note 64 *supra*. In *Waterman*, plaintiff was suing for infringement of a patent basing his right to sue on an agreement whereby the owner of the patent had granted to him "the sole and exclusive right to manufacture and sell" under the patent. The defendant contended that plaintiff had no right to sue for infringement because he was a mere licensee. The court held for the defendant on the ground that the agreement under which plaintiff claimed his right to sue was a license and not an assignment since there was no grant of the right to use the patented item. The court noted that:

> "The patentee or his assigns may, by instrument in writing, assign, grant and convey, either, 1st, the whole patent, comprising the exclusive right to make, use and vend the invention throughout the United States; or 2d, an undivided part or share of that exclusive right; or 3rd, the exclusive right under the patent within and throughout a specified part of the United States . . . A transfer of either of these three kinds of interest is an assignment. . . . Any assignment or transfer, short of one of these is a mere license. . . ."

Although *Waterman* is not a tax case, it has been cited in nearly every patent tax case involving the question of a sale or exchange within the past two decades.

trade or business be employed to characterize the motive in acquiring and holding these patents? A court could possibly construe such rights as held primarily for sale if no attempt has been made to devote the foreign patents to manufacturing or where the transferor corporation has solicited their sale, or had a history of selling its foreign industrial property rights.

In a recent case, *Armco Steel Corp. v. United States*,[59] the taxpayer granted foreign companies an exclusive license to manufacture and sell specialized steel in their respective countries. The government contended that the transferred property did not qualify for Section 1231 capital gain treatment. The contention was based on the argument that Armco's history of developing specialty steels and processes which it licensed abroad for manufacture made the current license just another in a long series of evolutions. Thus, the property was held primarily for sale to customers in the ordinary course of business. In rejecting the contention the court applied the *Malat v. Riddell*[60] holding on an apparent worldwide basis rather than distinguishing foreign from domestic operations.[61] Despite the court's finding, however, it appears likely more judicial pronouncements are essential before the issue is ultimately settled.

[2] Trademarks and Know-How. In contrast to copyrights and patents, trademarks and know-how are in a true sense "capital assets" as defined in Section 1221, since even if used in a trade or business,

[59] 263 F. Supp. (S.D. Ohio 1966). See also C.A. Norgren Co. v. United States, 268 F. Supp. 816 (D. Colo. 1967). In *Norgren* the court found the taxpayer was not in the trade or business of inventing and selling patents on the ground that it retained most of its patents and when one was disposed of, it was geographically limited and designed for commercial exploitation from which the taxpayer would profit. The conclusion was also supported by the infrequency of sales, the small number of customers and the type of consideration (i.e., a royalty percentage of sales).

[60] See discussion accompanying note 40 *supra*.

[61] In *Norgren*, note 59 *supra*, the government conceded that conceptual difficulties are encountered in determining how foreign patent rights were used in the taxpayer's trade or business. Such difficulty may be partially explained by the fact that the property characteristics in an invention are derived from its reduction to practice rather than from the issuance of a patent. Hence, a patent is merely a derivative right which, while creating an additional monopoly right, has its essential attributes determined by reference to the invention. See, e.g., Samuel E. Diescher, 36 B.T.A. 732 (1937). Some rather substantial definitional juggling would therefore be necessary to find that foreign patent rights were held primarily for sale to customers if the fundamental purpose of developing or acquiring the inventions was for use in the domestic corporation's manufacturing business. See Joseph A. Fields, 14 T.C. 1202, *aff'd* 189 F.2d 950 (2d Cir. 1951); Pike v. United States, 101 F. Supp. 100 (D.C. Conn. 1951).

cases,[76] it is not surprising that the Tax Court has recently moved to employ this exception in cases involving retained rights to use.[77]

Protection against contingencies snap-back clauses. Licensors commonly insert snap-back clauses into licensing agreements to insulate themselves to the greatest extent possible against loss of potential profit. Such a clause might provide for immediate reversion of all licensed property to the licensor under any of the following conditions:

(1) The expropriation or nationalization of the operations of the licensee;

(2) The filing of a bankruptcy or insolvency by the licensee or the appointment of a receiver;

(3) The sale of the controlling interest of the stock of the licensee to a buyer not approved by the licensor; or

(4) The failure of the licensee to pay specified amounts of royalties.

Snap-back provisions may hinder capital gain treatment if they encompass too much within their realm. However, permissible snap-back clauses include those which fall within the scope of the insubstantial rights exception or are exercisable only upon a condition subsequent.

In the leading case dealing with the condition subsequent exception, *Edward C. Myers*,[78] the licensor retained the right to terminate the agreement if a certain amount of royalties were not paid. The court rejected the Commissioner's argument that the provision was incompatible with the sale of a patent, holding that it was a mere condition subsequent that did not interfere with the passage of title. By contrast, the courts have generally denied capital gain treatment to agreements terminable at the will of the grantor, the rationale being that all beneficial interests have not been transferred unless occurrence of the condition subsequent is beyond the control of the transferor. Under such circumstances it is usually unavoidable that

the "insubstantial rights" test of the Section 1235 regulations to patent transfers governed by other capital gain provisions of the IRC.

[76] See, e.g., William S. Rouverol, 42 T.C. 186 (1964), licensing under specific claims of a patent. See ¶ 1.3b[2] *infra*.

[77] E.g., Taylor Winfield Co., 57 T.C. 33 (1971).

[78] 6 T.C. 258 (1946). See also Kronner v. United States, 110 F. Supp. 730, 734 (1953), vendor could cancel if vendee failed to "use its best efforts in marketing the invention"; Allen v. Werner, 190 F.2d 840 (5th Cir. 1951), vendor could cancel if vendee "violated the agreement in any way."

license or lease always produces ordinary income (offset by depreciation on the taxpayer's basis for the property).

An owner's interest consists primarily of the rights to make, use, and sell the article derived from the intangible property. Thus, for tax purposes a sale occurs only if the transfer includes substantially all such rights. Where there is a transfer of substantially all rights, a sale occurs for tax purposes regardless of whether the transfer is structured in terms of a sale or a license.[64]

¶ 1.3b Industrial Property Rights—Patents and Know-How[65]

[1] Transfer of All Substantial Rights. For tax purposes, patent licensing may be segregated into exclusive and nonexclusive licensing. Nonexclusive licensing always results in ordinary income. By contrast, exclusive licensing of all substantial rights to a patent can result in a capital gain characterized sale. Each patent and each invention is treated separately under the tax laws. Thus, a licensing agreement may exclusively license one patent and nonexclusively license another patent with characterization of the royalty income from each patent determined accordingly.

The operation of the "substantial rights" rule and the limited exceptions to it is illustrated by the following analysis of common restrictive licensing agreement provisions.

Restrictive licensing provisions and retained rights. Courts have generally adhered to the standard that the transfer of a patent suffices as a sale or exchange if it appears from the agreement and surrounding circumstances that the parties intended that the patentee surrender all substantial rights in and to the invention or an undivided part thereof.[66] Hence, the tax consequences have been gen-

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[64] The courts look to the substance of a licensing agreement to determine whether it is equivalent to a sale producing capital gain or a "mere license" producing ordinary income. See, e.g., Oak Mfg. Co. v. United States, 301 F.2d 259 (7th Cir. 1962); Merck & Co. v. Smith, 261 F.2d 162, 164 (3d Cir. 1958); Schmitt v. Comm'r, 271 F.2d 301, 305 (9th Cir. 1959); cf. Waterman v. MacKenzie, 138 U.S. 252, 256 (1896). "[T]he entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones." S. Rep. No. 1622, 83rd Cong., 2d Sess. 440 (1954).

[65] Many considerations regarding the transfer of all substantial rights in know-how are identical to those relating to patents. Deviations are analyzed in a separate section. See ¶ 1.3b[1] *infra*.

[66] See generally note 63 in regard to the criteria employed in determining if a sale or exchange has occurred. The evidential standard by which, for a con-

Where the licensor retains numerous other rights, however, a retained right to sue for infringement has been held a factor to be considered in determining whether there is a sale. The court in *Oak Manufacturing Co. v. United States* [85] stated that the right to control infringement suits was only one of a substantial "bundle of sticks" retained by the licensor which precluded a sale of the patent. By contrast, a right in the licensee to sue for infringement may be indicative of a sale when considered in the aggregate with other transferred rights.[86]

Reservation of a nonexclusive license. A license back does not change the nature of a complete sale if it follows the sale as an entirely separate transaction.[87] Where reservation of a nonexclusive license is contemporaneous with a sale, however, authorities differ as to the result. In an early case, *Kavanagh v. Evans,*[88] the Sixth Circuit found a sale notwithstanding the fact that the transfer was accompanied by simultaneous retention of a nonexclusive license by the licensor for exploitation of the patent rights in a specified area. The decision was premised upon the view that the licensor had retained an undivided part or share of its exclusive patent rights, a permissible fragmentation which does not interfere with the sale of a patent.[89] Subsequent decisions first questioned [90] and then dis-

[85] 301 F.2d 259 (7th Cir. 1962). See also Schmitt v. Comm'r, 271 F.2d 301 (9th Cir. 1959), and discussion ¶ 1.3b[2] *infra.* Cf. Vincent B. Rodgers, 51 T.C. 927, 931–932 (1969).

[86] Pike v. United States, 101 F. Supp. 100 (D. Conn. 1951). In *Pike,* the licensing agreement stated: "This agreement shall be construed as a license of the aforesaid patents and not an assignment thereof . . . ." The Commissioner strenuously argued the language was so clear and unambiguous that the license could not possibly be considered a sale. However, an examination of the agreement as a whole made it clear that in spite of the language of the parties the intent was clearly to transfer all beneficial interest to the licensee. The court noted that in addition to having exclusive rights under the patent with regard to use, manufacture, and sales, it was "very significant" that the licensee possessed the right to enforce the patent rights in his own name, retaining any recoveries as his own.

[87] Lamar v. Granger, 99 F. Supp. 17 (E.D. Pa. 1951); Arthur C. Ruge, 26 T.C. 138 (1956).

[88] 199 F.2d 234, 236 (6th Cir. 1951).

[89] For an analysis of permissible fragmentations see discussion ¶ 1.3b[2] *infra.*

[90] Walen v. United States, 273 F.2d 599 (1st Cir. 1959). In *Walen* the First Circuit observed (273 F.2d at n. 3): "We do not question that a taxpayer might sell a partial interest in an invention. However, to do so it should be a transfer of a measurable, identifiable share, and not of an undefined one of elastic proportions dependent upon how many subsequent shares the grantor might elect to create." Although recognizing the fragmentation principle, the

cluded if the transfer either omitted one of the rights from the agreement or failed to make an exclusive transfer of all of the rights. Thus, ordinary income treatment resulted where the only exclusive right transferred in the sale was the right to manufacture.[69] Moreover, before the insubstantial rights exception became widely recognized, courts determined that no sale occurred where an exclusive license failed to specifically grant the right to use the patent.[70] For instance, the Tax Court ruled that a licensor realized ordinary income where, in the absence of a formal agreement with a related corporation, no evidence was introduced to prove that the grant included the right to use.[71] Further, in *Bryon H. Pyle*[72] the Tax Court found no sale existed where neither the contract provisions nor extraneous evidence clearly established an intent to transfer the right to use, even though the retained right to use was of no apparent value to the licensor. The foregoing decisions were based on a strict interpretation of the *Waterman v. MacKenzie* criteria of "make, sell and use" for transfers of patent rights.[73]

Subsequently, judicial decisions began giving less weight to the *Waterman* criteria in determining the intent of the parties in regard to retained use rights. For instance, it was determined that failure to grant the right to use the patented article did not preclude an exclusive license from being the equivalent of a sale where the retained right of use was of no practical value to the licensor (i.e., where the retained rights are not substantial).[74] As the insubstantial rights exception has been acceded to by the Internal Revenue Service,[75] and applied by the Tax Court in other types of retained

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[69] William W. Taylor, T.C. Memo. 1970-325. Contra, Parke Davis & Co. v. Comm'r, 31 B.T.A. 427 (1934), involving an exclusive right to make and use, but not to sell. The retained right was determined to be insubstantial since the grantor was found to be able to exercise the right to sell only with the grantee's consent. See also Lawrence v. United States, 242 F.2d 466 (5th Cir. 1957).

[70] Broderick v. Neale, 201 F.2d 621 (10th Cir. 1952). The factual context indicates the grantor probably withheld the grant of exclusive use to protect his right to use the machines he had already constructed in his own business operations.

[71] National Bread Wrapping Co., 30 T.C. 550 (1958).

[72] T.C. Memo. 1964-94.

[73] See note 68 *supra*.

[74] Rollman v. Comm'r, 244 F.2d 634 (4th Cir. 1957), *rev'g* 25 T.C. 481 (1955), *on remand* T.C. Memo. 1957-182; E.I. duPont de Nemours & Co. v. United States, 296 F. Supp. 833 (D. Del. 1969), *rev'd on other grounds* 432 F.2d 1052 (3d Cir. 1970); Kirby v. United States, 297 F.2d 466 (5th Cir. 1961), *aff'g* 191 F. Supp. 571 (S.D. Tex. 1960).

[75] Rev. Rul. 64-56, 1964-1 C.B. 133. In effect, the ruling formally extended

ble, it is irrelevant for purposes of income characterization whether the licensor has reserved all ownership rights in a fragmented part of the patent or only a nonexclusive license.[94]

(2) Even if a retained nonexclusive license pertains to the entire scope of the license, it may be considered the retention of only an insubstantial right.[95]

Finally, it has been determined that the right to receive royalties from previously granted nonexclusive licenses is not inconsistent with a sale.[96]

Prohibition against sublicensing and subassignment. It is often advantageous for the licensor to restrict the licensee's right to subassign and sublicense under a patent. Such a limitation may serve to protect both parties to a license where, as is often the case, the purchase price is paid in installments. The Internal Revenue Service has stated that retention by the licensor of the right to prohibit sublicensing by the licensee "may or may not" preclude a sale "depending upon the circumstances of the whole transaction. . . ."[97] Al-

[94] Of course, if part of a patent is sold and another part is merely licensed (where for instance, a nonexclusive license is retained in an identifiable part of a patent), the licensing agreement should clearly state how the consideration is to be allocated.

[95] This approach may be inferred from the opinion of the Sixth Circuit in *Allied Chemical*. However, strong contrary views of the district court in *Allied Chemical* and the First Circuit in *Walen* to the effect that retention of a nonexclusive license is in and of itself a retention of a substantial right suggest such a retention is risky from a planning prospective.

[96] Bell Int'l Corp. v. Comm'r, 381 F.2d 1004 (Ct. Cl. 1967). Although the precise basis for the court's holding is unclear, the opinion pointed out that retention of a substantial right in a patent has reference to a substantial "property" right, i.e., the right to exclude others from making, using, or selling the patent grant, and not to the grantor's contractual right to obtain future payments in return for his prior conveyances of insubstantial property rights. See also Rollman v. Comm'r, 244 F.2d 634 (4th Cir. 1957), and General Aniline & Film Corp. v. Comm'r, 139 F.2d 759 (2d Cir. 1944). Contra, see First Nat'l Trust & Sav. Bank v. United States, 200 F. Supp. 374 (S.D. Cal. 1961), holding that a conveyance is required of all substantial rights given by a patent when issued and not those remaining in the transferor at the time of transfer. The Tax Court specifically rejected the above view in Donald C. MacDonald, 55 T.C. 840, 859 (1971). While the Tax Court initially waivered with respect to situations where a patent owner continues to drive royalties from a previously granted nonexclusive license, Transducer Prods. Co., 58 T.C. 329 (1972), it most recently extended full support to the *Bell International* approach. Van Dale Corp. 59 T.C. 390 (1972).

[97] Reg. § 1.1235-2(b)(3). Although the regulation applies specifically to IRC Section 1235 transfers, it also is reflective of the Treasury position regarding sublicensing restrictions in IRC Sections 1221 and 1231 transfers.

the grantor has retained a substantial interest in the transferred rights.[70] However, the reservation of the grantor's right to cancel at his own discretion will not preclude a sale where it appears that the reserved right has no practical value.[80] Also, a sale is not defeated where the grantee possesses a contingent right to terminate the agreement [81] or where the contingency creating a termination in the grantor is not within the control of either the grantor or the grantee (e.g., bankruptcy of the grantee).[82] The above cases indicate that no presumption of a license (rather than a sale) will arise merely because a grantor, who has transferred substantial rights under an agreement, attempts to secure payments of an installment price by insertion of contingency clauses in the agreement, so long as the transferred rights may not be hindered or interfered with by a discretionary act of the grantor.

Limitation on licensee's right to sue for infringement. A licensor may retain legal title for the purpose of bringing or defending infringement suits. Retention of legal title alone, without beneficial ownership, if held for the interest of another, is without value. Hence, a retained right to sue is not the reservation of a proprietary right in the asset, but rather a procedural matter which by itself is in no way determinative of whether the licensor has retained any substantial rights.[83] The result is the same where the licensee must join the licensor as an involuntary plaintiff.[84]

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[79] See Comm'r v. Sunnen, 33 U.S. 609 (1949); Bell Int'l Corp. v. United States, 381 F.2d 1004 (Ct. Cl. 1967); Pickren v. United States, 249 F. Supp. 560. (M.D. Fla. 1965), *aff'd* 378 F.2d 595 (5th Cir. 1967); Thomas D. Armour, 22 T.C. 181 (1954); Young v. Comm'r, 269 F.2d 89 (2d Cir. 1959); Gregg v. Comm'r, 18 T.C. 291, 302 (1952), *aff'd per curiam* 203 F.2d 954 (3d Cir. 1953); Reg. § 1.1235-2(b). However, in Magnus v. Comm'r, 259 F.2d 893 (3d Cir. 1958), the agreement provided that either party could terminate after two years by giving three months notice in writing, with the agreement to continue in effect unless such notice was given. The court held that despite this termination provision, the agreement considered as a whole did not actually give the grantor a right to terminate at will.

[80] Bannister v. United States, 262 F.2d 175 (5th Cir. 1958); Young v. Comm'r, note 70 at 92–93, *supra.*

[81] E.g., Allen v. Werner, note 78 at 842, *supra;* Lawrence v. United States, 242 F.2d 542 (5th Cir. 1957); Golconda Corp., 29 T.C. 506 (1957); Myers, note 66 at 264, *supra.*

[82] Lamar v. Granger, 99 F. Supp. 17, 37–38 (W.D. Pa. 1951); Comm'r v. Celanese Corp., 140 F.2d 339 (D.C. Cir. 1944).

[83] E.g., Bell Int'l Corp. v. United States, 381 F.2d 1004 (Ct. Cl. 1967); Merck & Co. v. Smith, 261 F.2d 162, 165 (3d Cir. 1958); Watson v. United States, 222 F.2d 689, 692 (10th Cir. 1955); Comm'r v. Celanese Corp., 140 F.2d 333, 342 (D.C. Cir. 1944); First Nat'l Bank v. United States, 136 F. Supp. 818, 822 (D.N.J. 1955); William S. Rouverol, 42 T.C. 186 (1964).

[84] Merck & Co. v. Smith, note 83 *supra.*

Aggregation of retained rights. Under the aggregation of retained rights doctrine, a licensor may discover that although various retained rights may individually be considered insubstantial, on a collective or aggregated basis, retention of such rights may have substantial value, which results in a transfer of less than all of the substantial right. The doctrine provides that in determining if a licensor has transferred all substantial rights the key question is whether the licensor has retained any rights which, in the aggregate, have substantial value.[103]

As the aggregation of retained rights doctrine is of relatively recent origin in licensing taxation,[104] its development is as yet incomplete and its ultimate dimensions unclear as to the scope and magnitude of retained rights which are substantial when aggregated. For instance, the *Waterman v. MacKenzie* definition provides that a sale occurs where the licensor conveys an exclusive right to make, sell, and use an invention, or an undivided or qualifying separable interest in such invention.[105] Yet, as previously discussed, one line of cases has held that a retained sublicensing right (which relates solely to the patent itself and in no way interferes with exploitation of the underlying invention) is properly includable in the aggregation process.[106] Further, in relation to separable interests the courts have encountered the Internal Revenue Service contention that field-of-use patent fragmentations do not produce a sale of separable property interests, but rather result in retained interests subject to

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[103] The historical origin of the doctrine is likely found in a statement by the Supreme Court in Waterman v. MacKenzie, 138 U.S. 252 (1966), which in effect provides that an assignment or transfer of less than exclusive rights to the whole patent, or an undivided or separable part of it constitutes a mere license and not an assignment. The doctrine was first formally promulgated by the Internal Revenue Service in Reg. § 1.1235-2(b):

> "All substantial rights to a patent. (1) The term 'all substantial rights to a patent' means all rights . . . which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. . . ."

Recent cases indicate that Internal Revenue Service has attempted to apply the doctrine to Section 1221 and 1231 transfers in addition to Section 1235 transfers.

[104] The doctrine first appeared in Watkins v. United States, 149 F. Supp. 718 (D. Conn. 1957), *aff'd* 252 F.2d 722 (2d Cir. 1958), *cert. denied* 357 U.S. 936 (1958), a case involving a Section 1235 factual context. In concluding the retained rights were collectively substantial, the conrt relied primarily on the number of retained rights rather than their qnalitative substance.

[105] Note 103 at 256, *supra.*

[106] See discussion accompanying note 97 *supra.* A reservation of title by the licensor for the purpose of bringing or defending infringements suits would also seem to be a retained right which would not interfere with exploitation of the invention by the licensee and therefore not subject to aggregation.

agreed with the approach taken in *Kavanagh*. In *Allied Chemical Corp. v. United States* [91] the Internal Revenue Service evidently convinced the taxpayer that the issue should be approached from a basis of substantial retained rights rather than fragmentation. Viewed from this prospective, the district court determined that reservation of a right to grant a nonexclusive license in the same field results in a transfer of less than all substantial rights in the patent. However, the court of appeals pointedly refused to rule on the matter, instead finding that under the facts of the case all the rights retained by the licensor were in the aggregate more than insubstantial.[92]

Although the above decisions suggest that reservation by the licensor of a nonexclusive license will in many instances preclude capital gain characterization of the resulting income, capital gain is not foreclosed under the following circumstances:

(1) Transfer of a fragmented part of a patent which is a measurable, identifiable interest will not preclnde capital gain. Cast in such a form, a retained nonexclusive license would appear clearly within the permissible fragmentation principle and outside the *Allied Chemical* "substantial retained interest" precept.[93] Where the fragmentation principle is applica-

court correctly surmised it was not applicable in the factual context of the *Walen* case, inasmuch as there the licensors had retained the right to grant other nonexclusive licenses covering the entire scope of the invention. No permissible fragmentation having taken place, it was held, under the particular facts of the case, retention of a right to grant multiple nonexclusive licenses resulted in a transfer of less than all substantial rights to the transferee.

[91] 66-1 U.S.T.C. ¶ 9212 (S.D.N.Y. 1966). However, the court's apparent refusal to consider application of the fragmentation principle to the *Allied Chemical* facts arose not from outright rejection of the principle, but rather from a failure to recognize it. (See 66-1 U.S.T.C. 85,375). The Court of Claims in *Bell International Corp. v. United States* also apparently failed to appreciate the factual distinctions between the *Kavanagh, Walen,* and *Allied Chemical* cases. (See 381 F.2d 1004 at n. 3.)

[92] 370 F.2d 697 (2d Cir. 1967).

[93] Note the manner in which the factual contexts of the *Kavanagh* and *Allied Chemical* cases differ. In *Kavanagh* the assignment related to all possible fields of use with a reserved nonexclusive license in only one of the permissible fields. Thus, a court could determine the licensor had sold a fragmented part of the patent equal to all fields of use except the one reserved. By contrast, *Allied Chemical* granted a license for the manufacture, use, and sale of wrappers in only the cheese field. (By itself, the license would probably have qualified as a sale of a fragmented part of a patent. See 1.3b[2] *infra*. However, the reserved nonexclusive license also related to the same field of use, that is, the entire scope of the license rather than merely a measurable, identifiable share or fragment of it. A court could therefore determine that more than an insubstantial right in the patent had been retained.

aggregation doctrine approach the intent analysis by indirection. An initial determination is made of the number and substance of retained rights. The retained rights are then collectively viewed to determine if the parties to the agreement could have retained such rights consistent with a sale intent. From a substantive viewpoint it would seem the indirect approach injects far more artificiality into determination of the subjective intent of the parties to the agreement than a direct analysis of retained rights in relation to intent. Significantly, all instances where a strict aggregation approach has been applied have involved at least one retained right which by itself has been determined to be substantial.[112]

Although recent decisions regarding the aggregation of rights doctrine have generally applied the doctrine in a manner favorable to the taxpayer, in litigation the Internal Revenue Service continues to insist upon an aggregate rather than individual valuation of retained rights.[113] Therefore, where capital gain characterization is sought the following guides may prove helpful:

(1) If possible, the licensing agreement should state that it is the intent of the parties that all substantial rights concerning exploitation (or ownership) of the property or an undivided interest therein be transferred.[114]

(2) Proposed retained rights should be analyzed from the standpoint of number and substantiality on both individual and aggregate basis to evaluate their total potential effect on the characterization of the agreement for taxation purposes.

Special considerations relating to know-how (trade secrets). For income taxation purposes, the only component of know-how which is at present, generally recognized as a property right subject to independent sale is a trade secret.[115] Yet, due to the nature of a trade

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[112] See, e.g., Watkins v. United States, note 104 *supra.*

[113] See also Rev. Rul. 58-353, 1958-2 C.B. 408, revoking Memo. 6490, 1950-1 C.B. 9.

[114] Note, although this statement may be indicative, the courts look to the entire agreement and its surrounding circumstances to determine the intent of the parties. See note 65 *supra.* On the other hand, a recitation that the licensor remains the "owner" of the patent has been held indicative of a license rather than a sale. Enterpen Financiera Sociedad v. United States, 108 F. Supp. 100 (Ct. Cl. 1952).

[115] United States Mineral Prods. Co., 52 T.C. 177 (1969). Although some indication that nonsecret know-how may qualify independently as property exists, currently such know-how has been allowed capital gain treatment only if incidental to the transfer of patents or trade secrets. See discussion accompanying notes 31 to 34, *supra.*

though no court has ruled that reservation of such a right in and of itself is sufficient to preclude a sale for tax purposes, a few courts have in effect given credence to the Service approach by holding that where restrictions against sublicensing and subassignments were among a number of restrictions they were to be taken into account in determining if the totality of retained rights was more than insubstantial.[98]

However, what appears to be a better view is contained in a line of cases of which *Rollman v. Comm'r* [99] is typical. In *Rollman*, the transfer documents expressly provided that the licensee could not grant sublicenses under the patents except with the written consent of the transferor. The court held that such a limitation does not interfere with the full use of the patent by the assignee. Moreover, the court stated the assignor retains no use in the patent for himself by reason of the limitation since he has granted the exclusive rights to the assignee and cannot grant a sublicense without the purchaser's consent.[100]

The basis for the court's holding precedes from *Waterman v. MacKenzie* [101] which provides that all substantial rights to a patent are comprised of the exclusive right to make, use, and sell the patented invention. A retained prohibition against subassignments and sublicenses in no way interferes with exploitation of the above property rights, but rather pertains to the patent itself. Hence, it would seem that such a prohibition cannot effect any retention of a "property right" as it is defined in *Waterman* since the prohibition relates to a right beyond the boundary of the term and, therefore, is not inconsistent with the passage of ownership.[102]

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[98] Oak Mfg. Co. v. United States, 301 F.2d 259, 262 (7th Cir. 1962); Schmitt v. Comm'r, 271 F.2d 301, 307 (9th Cir. 1959), *aff'g* 30 T.C. 322 (1958).

[99] 244 F.2d 634 (4th Cir. 1957). See also E.I. duPont de Nemours & Co. v. United States, 432 F.2d 1052 (3d Cir. 1970); Bell Int'l Corp. v. United States, 381 F.2d 1004 (Ct. Cl. 1967); William W. Taylor, P-H T.C. Memo. ¶ 70,325; Vincent B. Rodgers, 51 T.C. 927, 931–932 (1969); Allen v. Werner, 190 F.2d 840, 842 (5th Cir. 1951); Parke, Davis & Co., 31 B.T.A. 427 (1934); Watson v. United States, 222 F.2d 689 (10th Cir. 1955). (Excellent discussions and analyses of the area are contained in the *Bell International Corp.* and *Vincent B. Rodgers* opinions.)

[100] Rollman v. Comm'r, note 96 at 640, *supra.*

[101] 138 U.S. 252 (1891). For a discussion of the *Waterman* criteria see note 64 *supra.*

[102] Although no court explicitly stated this view, it appears to be a logical inference from discussion of the issue in the *Rollman* line of cases. The potential importance of this distinction to the cumulative retained rights approach is found in the discussion accompanying note 106, *infra.*

> "[T]he transfer of a trade secret may be a transaction equivalent to a sale, in the same manner that a patent assignment is considered a sale. In each case the transferee or assignee gets more than mere information. Of greater importance, he obtains what he believes to be a competitive advantage a means for commercial exploitation and reward." [122]

Further, the court noted that in contrast to a patent which provides a monopoly created by law a trade secret derives much of its value from the fact of its secrecy. It is truly valuable only so long as it is secret, and therefore provides an advantage over competitors. Thus, no disposition of a trade secret is complete without some transfer of the right to prevent unauthorized disclosure.[123]

The actual manner employed in transferring the right to prevent unauthorized disclosure of a trade secret may also generate divergent results. Utilizing a patent-oriented approach to trade secret transfers, the Tax Court in *Franklin S. Speicher* [124] determined that the owner of a trade secret who expressly transfers *all* his ownership rights, impliedly transfers the right to prevent the transferor's further use or disclosure of the trade secrets and the transaction should be recognized as a sale.

By contrast, in *Stalker v. United States* [125] the transferor-taxpayer had entered into a contract whereby it agreed to make secret processes and know-how relating to the manufacture of turbine components available to another corporation. Even though the contract did not unequivocally transfer the right to prevent disclosure, the taxpayer contended the transferee impliedly had such a right since it was implied in the sale of trade secrets. The court found the argument without merit because it assumed a sale, the precise point in issue.[126] Since the transferor had failed to expressly transfer its most important right, the right to prevent disclosure by it to third parties, the court ruled the transaction did not qualify as a sale.[127]

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[122] E.I. duPont de Nemours & Co. v. United States, 288 F.2d 904, 911, 129 U.S.P.Q. at 478 (Ct. Cl. 1961). Competitive advantage is a definitional component of trade secret. See Restatement Torts § 757, Comment b at 5 (1939).

[123] *Id.* at 912. For a discussion of the area see Creed and Bangs, "*'Know-How' Licensing and Capital Gains,*" 4 Patent, Trademark & Copyright J. of Research & Education 93,101 (1960).

[124] 28 T.C. 938 (1957), *acq.* in 1958-2 C.B. 7.

[125] 209 F. Supp. 30, 135 U.S.P.Q. 124 (E.D. Mich. 1962).

[126] *Id.* at 34, 135 U.S.P.Q. at 127. In so holding, the court relied heavily upon E.I. duPont de Nemours & Co. v. United States, 288 F.2d 904 (Ct. Cl. 1961). Additionally, the court determined the transferred rights were not exclusive for the territory.

[127] Had the taxpayer's transfer of all its interest been unequivocally ex-

aggregation.[107] Finally, the quantitative weight or magnitude of each retained right has been an area marked by widely differing approaches.

In an early aggregation decision, *Watkins v. United States*,[108] the Second Circuit Court of Appeals did not individually weight each retained right. Instead, it merely found the retained rights in combination were substantial. Later decisions by other courts, while generally acknowledging the aggregation of retained rights doctrine, have analyzed retained rights on an individual basis. Only where at least one retained right has been determined to be substantial, has a license rather than sale characterization of the transfer resulted for taxation purposes.[109] The recent holdings indicate that the courts, with the exception of the Second Circuit,[110] have not aggregated rights determined to be immaterial or insubstantial in value for purposes of determining whether all substantial rights have been transferred.[111]

The courts adopting the above approach assess the basic criteria of the parties' intent in a direct manner. A retained right which is procedural or immaterial and not inconsistent with a sale intent is not includable for aggregation purposes. Thus, in reality no aggregation is made unless a retained right is more than immaterial. Generally, retention of such a right would, by itself, be sufficient to preclude a sales characterization. By contrast, courts employing a strict

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[107] See discussion accompanying note 142 *infra*.

[108] Note 104 *supra*. The aggregation of retained rights doctrine was also employed by the district court in Bannister v. United States, 161 F. Supp. 298 (S.D. Tex. 1958), in a Section 1235 context. However, the holding was reversed by the Fifth Circuit which in its opinion analyzed the retained rights on an individual basis and determined them either to be insignificant or without practical value. 262 F.2d 175 (5th Cir. 1959). See also Oak Mfg. Co. v. United States, 301 F.2d 259 (7th Cir. 1962), where the court analyzed the retained rights on an individual basis, but evidently viewed them cumulatively in concluding the parties intended a license rather than a sale. The Tax Court applied the aggregation of retained rights doctrine in Joe L. Schmitt, Jr., 30 T.C. 322 (1958) (a Section 1235 case), which was affirmed by the Ninth Circuit. 271 F.2d 301 (9th Cir. 1959). However, in recent decisions the Tax Court has analyzed retained rights on an individual rather than collective basis. See, e.g., Vincent B. Rodgers, 51 T.C. 927 (1969), and Taylor-Winfield Corp., 57 T.C. 205 (1971).

[109] Merck & Co. v. Smith, 261 F.2d 162, 164 (3d Cir. 1958); Bell Int'l Corp. v. Comm'r, 381 F.2d 1004 (Ct. Cl. 1969); Vincent B. Rodgers, note 108 *supra;* Transducer Patents Co., 58 T.C. 329 (1972). See also E.I. duPont de Nemours & Co. v. United States, 432 F.2d 1032 (3d Cir. 1970), involving combined patent and know-how transfers, and United States Mineral Prods. Co., 52 T.C. 177 (1969), involving know-how.

[110] See Allied Chem. Corp. v. United States, 370 F.2d 697 (2d Cir. 1967).

[111] See cases cited, note 108 *supra*.

in *Waterman v. MacKenzie* [132] which provided that a patentee or his assignee may convey either "an undivided part or share of that exclusive right; or . . . the exclusive right under the patent within and throughout a specified part of the United States." [133] In the taxation area, however, the *Waterman* criteria have been applied in an expanded manner.

Undivided interests. A sale or exchange clearly occurs where *A* transfers to *B* an undivided interest (e.g., one-half) in a patent or know-how.[134] Nevertheless, as previously noted, the transaction qualifies for capital gain treatment only if all substantial rights to the property in question are transferred.[135] For instance, a transfer of an undivided interest in Section 1221 know-how will not be afforded capital gain treatment if the agreement contains a provision limiting the time of its force and effect.[136] Therefore, where undivided interests as well as other fragmentations are concerned the taxplanner should be mindful of the important bearing which the "all substantial rights" test has to the fragmentation area.

Geographical limitations. Following the language of the Supreme Court in *Waterman v. MacKenzie,* subsequent cases have generally sustained capital gain treatment on patent transfers even though the transferee's rights were subject to specific geographical limitations. Domestically, this has been the result where the taxpayer entered into two essentially identical agreements for the transfer of the exclusive right to manufacture, use, sell, and distribute under certain patents held by him—one agreement for exclusive rights throughout the United States east of the Mississippi River, the other for the same rights west of the river.[137] Similarly, the transfer of all exclusive rights under a patent "within the United States" was held to be a sale of that portion of the patent and not a mere license.[138]

Where licensing of foreign patents is concerned, the most com-

[132] 138 U.S. 252 (1896).

[133] *Id.* at 256.

[134] Parke, Davis & Co., 31 B.T.A. 427 (1934).

[135] See discussion accompanying notes 89 to 93, *supra.*

[136] Pickren v. United States, 249 F. Supp. 560 (M.D. Fla. 1965).

[137] Vincent A. Marco, 25 T.C. 544 (1955).

[138] Watson v. United States, 222 F.2d 689 (10th Cir. 1955). In another case where the issue was whether or not an industrial limitation on a patent transfer would preclude a sale, the Commissioner conceded that a geographical limitation would be permissible. United States v. Carruthers, 219 F.2d 21 (9th Cir. 1955).

secret its licensing entails special considerations, some of which Revenue Ruling 64-56 [116] effectively highlights:

> "The unqualified transfer in perpetuity of the exclusive right to use a secret process or other similar secret information qualifying as property within all the territory of a country . . . will be treated as the transfer of all substantial rights in the property in that country." [117]

The ruling is accurate with respect to the requirement of an exclusive and perpetual right to use. Since a trade secret lacks a definitive useful life, only a transfer in perpetuity of an exclusive right to a trade secret will result in a transfer for income taxation purposes.[118] On the other hand, the ruling is somewhat misleading as to other requirements for transfer of all the substantial property in a trade secret licensing transaction. In particular, as the property right in a trade secret essentially consists of the right to prevent a wrongful or unauthorized use or disclosure,[119] current decisions have found a transfer of all substantial rights lacking unless the licensor not only transfers the exclusive right to use, but conveys the right to prevent all others from using or disclosing.[120]

In *E. I. duPont de Nemours & Co. v. United States*,[121] the taxpayer sought capital gain treatment for the proceeds from the transfer of an electrolytic process for producing metal sodium. The transferor agreed not to assert any patents concerning the process against the licensee. However, the terms of the agreement did not restrict duPont from further disclosure of the process. In dealing with the question of whether a sale of the secret process had occurred the court stated:

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[116] 1964-1 (Pt. 1) C.B. 133.

[117] *Id.* at 135. While the ruling does not directly concern licensing, it illustrates the Service's view regarding the nature of secret technology.

[118] The statement in the Revenue Ruling is derived from an analogous concept established by E.I. duPont de Nemours & Co. v. United States, 288 F.2d 904 (Ct. Cl. 1969), and Stalker Corp. v. United States, 209 F. Supp. 30 (E.D. Mich. 1962). A trade secret, if kept secret, may have a perpetual life, and thus is analogous to a trade name in this regard. Reid v. Comm'r, 26 T.C. 622 (1956), and Seattle Brewing & Malting Co. v. Comm'r, 6 T.C. 856 (1946), hold that capital gain treatment will be afforded to royalties received from an exclusive and perpetual transfer of a trade name. Recent cases characterizing income as ordinary when it results from licensing of trade secrets for limited time periods include Taylor-Winfield Corp., 57 T.C. 33 (1971), and PPG Indus., Inc., 55 T.C. 928 (1970).

[119] E.I. duPont de Nemours & Co. v. United States, note 118 at 911, *supra.*

[120] See, e.g., cases cited note 118 *supra.*

[121] Note 118 *supra.*

the taxpayer recognized *Waterman* as a classic guideline case in the area. However, the court stated that it could see no appreciable difference between division of a patent into different geographical areas (as set out in *Waterman*) or into different fields of use so long as all substantial property rights to the particular property transferred are granted.[144] Hence, even though the *Carruthers* court did accept the proposition that a transfer of a field-of-use fragmented part of a patent may qualify as a sale, the impact of its holding was limited to factual contexts in which all substantial rights to an entire patent are granted. The decision was grounded on the fact the taxpayer had demonstrated in the lower courts that the value of the patents outside the tuna industry was at best speculative. Thus, the court determined that all substantial rights to the entire patent had been transferred although the transferred rights were limited to a field of use, the tuna industry.[145]

The next step in development of the field-of-use fragmentation in connection with Sections 1221 and 1231 transfers was taken by the Third Circuit Court in *Merck & Co. v. Smith.*[146] There the transferred patent covered certain chemical compounds known as sulfa drugs. The rights granted covered only one of the claims in the general patent, namely sulfadiazine. Rights in the other claims were reserved to the transferor. In holding a sale resulted, notwithstanding the reservation, the court stated:

> "One generic patent was issued to the original patentee. But there were species claims and the species were separate inventions. A single patent may issue for two or more separate inventions as said in Special Equipment Co. v. Coe . . . ." [147]

Hence, the primary importance of the *Merck & Co.* decision to the development of the field-of-use fragmentation sale doctrine rests in its recognition that for taxation purposes different bundles of property rights, each consisting of a separate invention, may be the subjects of a sale whether they are contained in a single patent or formally segregated into multiple patents. Of course, such an approach has significant tax implications where multiple-invention patent fragmentation occurs.

Additionally, while not entirely germane to its holding, the *Merck*

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[144] *Id.* at 24.

[145] Note 143 at 25, *supra.*

[146] 261 F.2d 162 (3d Cir. 1958).

[147] *Id.* at 165.

Since a licensing agreement transferring proprietary know-how (trade secrets) must contain either a restrictive clause on the part of the licensor with respect to unauthorized disclosure or an express transfer of all ownership rights in the trade secrets, the licensor ought to carefully consider what know-how should be properly delineated "proprietary." Only know-how reasonably qualifying as proprietary should be included since nonproprietary know-how may be transferred separately in the agreement with the licensee required to keep such know-how in secrecy, while the licensor need not so limit himself. Of course, royalties on such nonproprietary know-how generally are not subject to capital gains treatment.[128]

Finally, while the *duPont* decision and other cases discussed above generally follow the reasoning used in patent tax cases in the rights retained in trade secrets transfers, a complete analogy appears somewhat dubious. For instance, in *Pickren v. United States*[129] the court, in determining whether the parties to a trade secret contract intended to make a complete transfer of all rights, attached significance to the transfer being only the exclusive right "to manufacture, or have manufactured, use and sell the products derived from the secret formulas" instead of granting "rights in and to the secret formulas."[130] Thus, it appears the licensor seeking capital gain from transfer of proprietary trade secrets should cautiously approach any limitation with respect to use.[131]

[2] Transfer of Fragmented Interests. A license may qualify as a sale or exchange under Sections 1221 or 1231 even though it transfers only a portion of the licensor's total bundle of rights in a patent or trade secret. Such a sale or exchange will occur when a permissible fragmented (or separable) interest is transferred. The initial basis for determining a permissible fragmentation was formulated

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pressed in the agreement, the *Speicher* rationale may have proved a persuasive argument in relation to the implied restriction contention.

[128] Note the exception for nonproprietory know-how which is incidental or ancillary to a qualifying transfer of patents or trade secrets. See discussion accompanying notes 31 to 36, *supra*.

[129] 378 F.2d 595 (5th Cir. 1967).

[130] *Id.* at 597, 600.

[131] For example, sale of a patent coupled with a nonexclusive license back can result in capital gain to the seller since two separate transactions are deemed to occur, i.e., the sale of a patent followed by a nonexclusive license back to the seller. See discussion accompanying notes 87 to 92, *supra*. Yet, it is doubtful a trade secret transferor who retains a substantial right to continue to use the secret is entitled to capital gain. See Harold P. Whitmore, 24 T.C. Memo. ¶ 33,638 (1965).

patent field-of-use fragmentation presently seems well infused in the Sections 1221 and 1231 capital gains provisions.[153] Yet, the tax planner should exercise some caution when contemplating such fragmentations when uncertainty remains with respect to:

(1) Whether all field-of-use fragmentation transfers automatically qualify as sales or will a transfer of a relatively minor field of use in relation to the total value of the patent not be considered a transfer of substantial rights?

(2) At what point will the addition of restrictions, other than field of use, become so great as to preclude a transfer of substantial rights?

Thus, taxpayers might be well advised to fragment patents, especially single-invention patents, only on either a pure or substantial field-of-use basis.

Finally, it should be noted that where qualifying know-how (when not ancillary to the transfer of patent) is transferred with a field-of-use limitation, the transfer will be treated for taxation purposes in the same manner as a patent assignment.[154]

¶ 1.3c Trademarks

[1] Pre-1970 Transfers. Prior to 1970 there were no specific provisions limiting potential capital gain treatment on transfers of trademarks. Thus, when pre-1970 trademark transfers are concerned the tax consequences are generally similar in nature to those relating to patents and know-how. For instance, a pre-1970 assignment of a trademark clearly satisfies the sale or exchange requirement.[155] Likewise, the grant of an exclusive and perpetual license is ordinarily sufficient to transfer the property interest of the transferor in the trademark.[156] The fact that the consideration for the transfer is measured by a fixed percentage of the selling price of the products bearing the trademark or any other method based on sale, production, or use will not influence the capital gain aspects of the sale.[157]

Where trademark rights are retained, tax characterization of the

[153] However, the picture under Section 1235 is an entirely different matter. See discussion ¶ 2.3b[3] *infra.*

[154] Note 139 *supra.*

[155] United States v. Adamson, 161 F.2d 942 (9th Cir. 1947).

[156] Seattle Brewing & Malting Co., 6 T.C. 856 (1946); See also Thomas D. Armour, 22 T.C. 181 (1954); National Bread Wrapping Mach. Co., 30 T.C. 550 (1958).

[157] Rose Marie Reid, 26 T.C. 622 (1956); Comm'r v. Hopkinson, 126 F.2d 406 (2d Cir. 1942); Rev. Rul. 58-353, 1958-2 C.B. 408. However, serious

mon separable interest transferred is probably the one relating to a particular geographic territory. A sale clearly occurs when a license is limited to the country of the issuance of the patents since the licensee has received all the rights that can be granted in the particular patent.

Geographically limited grants of trade secrets (when not ancillary to the transfer of patents) are less certain, as there is no inherent territorial limit in their status. The courts have determined that the grant of a geographically limited trade secret is a sale if the right to prevent unauthorized disclosure is transferred.[139] However, an important element in determining whether all substantial rights in a geographically limited grant of a trade secret have been transferred is the protection afforded trade secrets under the law of the transferee's country.[140] A sale will occur only if the right to prevent disclosure in the transferee's country is an effective right and such right (and therefore all substantial rights) is transferred.[141]

Field-of-use fragmentations.[142] Although the Supreme Court did not specifically refer to field-of-use fragmentations in *Waterman v. MacKenzie*, subsequent judicial pronouncements beginning with *United States v. Carruthers*[143] have afforded an expansive interpretation of the *Waterman* test with respect to such fragmentations of patents. In *Carruthers* the taxpayer assigned all rights under the patent owned by him to a corporation, but limited their use to the tuna industry. The court pointed out that both the government and

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[139] See E.I. duPont de Nemours & Co. v. United States, 288 F.2d 904 (Ct. Cl. 1961); Stalker Corp. v. United States, 209 F. Supp. 30 (E.D. Mich. 1972); Commercial Solvents Corp., 42 T.C. 455 (1954); United States Mineral Prods. Co., 52 T.C. 170, 198 (1969). The cases relied heavily upon patent sale principle to determine whether a trade secret had been sold. The Internal Revenue Service in Rev. Rul. 64-56, 1964-1 (Pt. 1) C.B. 133, 135, dealing with tax-free transfers of secret processes to controlled corporations, indicated an apparent approval of the foregoing analysis.

> "The unqualified transfer in perpetuity of the exclusive right to use a secret process or other similar secret information qualifying as property within all the territory of a country, or the unqualified transfer in perpetuity of the exclusive right to make, use, and sell an unpatented but secret product within all the territory of a country, will be treated as a transfer of all substantial rights in the property."

[140] See note 25 *supra*.

[141] See E.I. duPont de Nemours & Co. v. United States, note 139 *supra*, at 912; Commercial Solvents Corp. note 139 *supra*.

[142] For a detailed discussion see, Bischel, "Developments in patent transfers provide clues to capital gain via fragmentation," 36 J. Taxation 156 (1972), 4 Patent L. Rev. 203 (1972).

[143] 219 F.2d 21 (9th Cir. 1955).

[2] Section 1253 and the Retention of Significant Rights. Under Section 1253, capital gain or loss treatment is precluded for amounts received from the transfer, after 1969,[166] of a franchise, trademark, or trade name if:

(1) The transferor retains any significant power, right, or continuing interest with respect to the transfer,[167] or

(2) The amounts received are contingent upon the productivity, use, or disposition of the transferred franchise, trademark, or trade name.[168]

Section 1253(b)(2) defines the term "significant power, right, or interest" as including, but not limited to the following six rights with respect to the interest transferred.

(1) A right to disapprove any assignment of the interest, or any part of the interest;

(2) A right to terminate at will;

(3) A right to prescribe the standards of quality of products used or sold, or of services furnished, and of the equipment and facilities used to promote the product or service;

(4) A right to require that the transferee sell or advertise only products or services of the transferor;

(5) A right to require that the transferee purchase substantially all his supplies and equipment from the transferor; and

(6) A right to payment contingent on the productivity, use, or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.

Further, the proposed Section 1253 regulations [169] reflect the House of Representatives' proposal regarding the section.[170] They add the following as significant powers if retained by the transferor:

(1) A right to prevent the transferee from removing equipment

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[166] There is, however, one exception. Even if the transfer occurred before December 31, 1969, the transferee may elect to have the deduction provisions of Section 1253(d) apply, but only with respect to payments made in taxable years beginning in 1970 through 1979 inclusive. See Prop. Reg. § 1.1253-3(a).

[167] I.R.C. § 1253(a).

[168] I.R.C. § 1253(c).

[169] Proposed Treasury Decision published July 15, 1971.

[170] H. Rep. No. 413 (Pt. I), 91st Cong., 1st Sess. 162 (1969).

& Co. court viewed the *Carruthers* decision as standing for the proposition that one who owns a single invention patent may sell its use in a particular industry.[148] Nevertheless, the Tax Court was bestowed the initial opportunity to actually pass upon the above approach in *Estate of Laurent, Sr.*[149] In *Laurent*, the owner of a closure joint with an improved seal granted an exclusive license restricted to the invention's application to gate valves, a specific and identifiable product within the valve industry. In holding the transferor to be entitled to capital gain treatment the court declared:

> "[E]ither the original patent application was one which could be considered to cover other areas in addition to gate valves or not. If the former, this case should be considered similar to Merck & Co. v. Smith . . . .
>
> "If on the other hand no substantial use for the underlying patent existed except in the gate valve field, then by his transfer of rights under the application exclusive of their relation to gate valves, decedent actually parted with all substantial rights under the underlying patent. See United States v. Carruthers." [150]

With one possible exception,[151] the conclusion of the Tax Court concerning field-of-use fragmentation of single invention patents has been strongly supported by subsequent decisions, most recently by the Third Circuit in *E. I. duPont de Nemours & Co. v. United States*.[152] Thus, the principle of both single- and multiple-invention

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[148] *Id.*

[149] 34 T.C. 385 (1960).

[150] *Id.* at 398.

[151] Redler Conveyor Co. v. Comm'r, 303 F.2d 567 (1st Cir. 1962), *aff'g* T.C.M. 1961-82. In *Redler*, an owner of certain patents transferred interests therein subject to numerous restrictions and limitations including: a term of years less than the remaining lives of the patents, limiting the granting of sublicenses, limiting the licensees' right to prosecute infringements, and limiting the use of the patents in the building heating industry. The Tax Court summarily disposed of the case by concluding the restrictive clauses were consistent with an intention to grant nonexclusive licenses. The First Circuit affirmed the Tax Court in its reasoning, but in so doing also alluded to field of use fragmentation and reaffirmed its prior strict approach to the *Waterman* criteria in Walen v. United States, 273 F.2d 599 (1st Cir. 1959). Completely absent was any discussion of judicial developments in the area, although the court did make a statement regarding retention of valuable rights which was almost identical to the *Carruthers* holding.

[152] 432 F.2d 1052 (3d Cir. 1970). Significantly, the government decided not to appeal the decision to the Supreme Court. The reasoning of *Merck & Co.* relating to single invention patent field of use fragmentation was also cited with approval in Bell Int'l Corp. v. United States, 381 F.2d 1004 (Ct. Cl. 1967).

Finally, it is important to note that the term "transfer" is given a broad connotation for Section 1253 purposes. The definition includes not only initial transfers of franchises, trademarks, and trade names, but also the renewal of existing agreements. Under prior law, it had been determined that modification of a franchise resulted in a new contract.[174] Hence, it would appear that modifications of pre-1970 agreements may invite application of the Section 1253 significant retained rights and contingency payment rules.

¶ 1.3d Copyrights

When a copyright qualifies as a capital asset or Section 1231 property, the tax attributes flowing from fragmentation or retention of rights by the transferor are generally similar to those involving patents. For instance, a copyright may be fragmented on a field-of-use basis without loss of capital gain status. The Service has ruled that a copyright is divisible into separate properties, any one of which may be the subject of a sale.[175] Thus, the transfer of an exclusive right for the remaining term of a copyright is treated as a sale even though the transfer is restricted to a particular medium.[176] Also, it has been determined that a copyright transfer may qualify as a sale in spite of a geographical limitation.[177] Finally, in Revenue Ruling 60-226 [178] the Service agreed that the sale status of copyrights, as well as patents, is not affected by the fact that the consideration received is measured by a percentage of receipts from the sale, performance, exhibition, or publication of the copyrighted work, or measured by the number of copies sold, performance given, or exhibitions made of the copyrighted work, or whether such receipts are payable over a period generally coterminous with the transferee's use of the copyrighted work.[179]

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[174] Brook v. Comm'r, 360 F.2d 1011 (2d Cir. 1966).

[175] Rev. Rul. 54-409, 1954-2 C.B. 174. Prior to the ruling the government contended that a copyright was indivisible with the result that a transfer of anything less than the title to the entire copyright was a license instead of a sale. However, the view was rejected by the courts. See Gershwin v. United States, 150 F. Supp. 799 (Ct. Cl. 1957), transfer of motion picture rights to certain musical compositions held to result in capital gain; Herwig v. United States, 105 F. Supp. 384 (Ct. Cl. 1952), involving the sale of motion picture rights by Kathleen Windsor to "Forever Amber"; Joseph A. Fields, 14 T.C. 1202 (1950), *aff'd* 189 F.2d 950 (2d Cir. 1951).

[176] Rev. Rul. 54-409, note 175 at 176, *supra.*

[177] Wodehouse v. Comm'r, 166 F.2d 986 (4th Cir. 1948), *rev'd and remanded* 337 U.S. 369 (1949).

[178] 1960-1 C.B. 26.

[179] *Id.* at 27.

transfer is dependent upon the substantiality of their value.[158] For example, retention of bare legal title under an exclusive and perpetual license agreement does not in any manner restrict the transferee's enjoyment of the trademark. Accordingly, such title retention is insubstantial and will not affect the sale characterization of a trademark transfer.[159]

Additionally, trademark licensing agreements usually contain a provision under which the transferor retains some degree of control over the quality of the product bearing the trademark to avoid a possible constructive abandonment. In an early trademark case, *Seattle Brewing & Malting Co.*,[160] an exclusive license agreement transferred two trade brands. The agreement included a provision requiring the transferee, in manufacturing and marketing the trade names, to at all times equal "the quality of similar products then manufactured and marketed under the said trade names and brands by the transferor. . . ." [161] Moreover, the agreement empowered the transferor to cancel the agreement in the event the transferee failed to meet the above condition.[162] The Tax Court held that a transferor could definitely control the quality of the product produced by the transferee and marked with the trade names without precluding a sale.[163]

By contrast, in later cases involving transfers of commercial franchise agreements the courts differed seriously with respect to the conditions under which a transferor may, without loss of sale status, terminate the agreement for breach because the transferee has not maintained acceptable standards of quality.[164] The ultimate result of the conflict was enactment of Section 1253 in the Tax Reform Act of 1969.[165]

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conflicts arose between the courts in dealing with transfers of certain commercial franchises where significant control was retained over the franchisee's operations and where payment was contingent upon the franchisee's sales or use. (For a summary of the cases, see United States v. Wermentin, 354 F.2d 757 (8th Cir. 1965).) In 1969 Congress enacted Section 1253, resolving the question in favor of treating the receipts from customary forms of franchise grants as ordinary income. See discussion ¶ 1.3c[2] *infra*.

[158] Seattle Brewing & Malting Co., note 156 *supra*.

[159] *Id.*

[160] Note 156 *supra*, 36 T.M.R. 214 (1946).

[161] *Id.* at 859, 36 T.M.R. at 217.

[162] *Id.* at 861, 36 T.M.R. at 219.

[163] *Id.* at 870, 56 T.M.R. at 227.

[164] For a summary of the cases see United States v. Wermentin, 354 F.2d 757 (8th Cir. 1965).

[165] Sec. 516(c)(1) of P.L. 91-172, Dec. 30, 1969 (qualified effective date rule in Sec. 516(d)(3) of P.L. 91-172, Dec. 30, 1969).

the product would stand up from the standpoint of shelf life, effectiveness, and consistency was the actual reduction to practice requirement met.[186] Thus, while the "reduction to practice" requirement does not mean that whatever is being worked upon has to be in shape to be commercially marketable it does require a demonstration that a workable invention exists.[187]

If future improvements are sold together with an existing patent, the holding period of the improvements begins at the same time as the holding period of the basic invention. This conclusion is premised on the fact that at the time of the original transaction, the patent owner transfers not only the patent, but also the right to fully utilize future improvements which might infringe the basic patent. Therefore, a valuable right relating to improvements is transferred at the time of the original transaction, even though the improvements may not have even been conceived, much less reduced to practice, at that time.[188] Finally, it should be observed that under some circumstances (e.g., where a gift is made) [189] the individual who receives the invention or patent may include in his holding period the period for which the invention or patent was held by his transferor. This process, commonly known as tacking, is permitted if the basis of the asset in the hands of the transferee is determined by reference, in whole or in part, to its basis in the hands of the transferor.[190]

The tax consequences respecting the holding periods of trade secrets, trademarks, and trademark applications are governed by the same principles as those involving patents and inventions.[191] However, a slightly different rule applies to creative works and

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[186] See Max A. Burde, 43 T.C. 252 (1964) (dictum), *aff'd* 352 F.2d. 995 (2d Cir. 1965), *cert. denied* 383 U.S. 966. Other examples include Carl G. Dreymann, 11 T.C. 153 (1948), and Paul L. Kuzmick, 11 T.C. 288 (1948).

[187] Radio Corp. of Am. v. International Standard Elec. Corp., 232 F.2d 726, 730 (3d Cir. 1956); Farrand Optical Co. v. United States, 325 F.2d 328, 533 (2d Cir. 1963) (nontax cases).

[188] See Kronner v. United States, 110 F. Supp. 730 (Ct. Cl. 1953); Heil Co., 38 T.C. 989 (1962), *acq.* 1963-1 C.B. 4.

[189] Tacking is also permitted where an invention or patent is exchanged for stock in a corporation, I.R.C. § 1223(1). See Lee v. United States, 302 F. Supp. 945 (E.D. Wis. 1969).

[190] I.R.C. § 1223(2).

[191] United States Mineral Prods. Co., 52 T.C. 177 (1969), know-how; Seattle Brewing & Malting Co., 6 T.C. 856 (1946), trademarks. However, trausfers of trade secret improvements should be segregated on a proprietary/non-proprietary basis. To satisfy the holding period requirements, the proprietary portion should be treated so as to vest rights in the transferee more than six months after the reduction to practice thereof.

from outside the territory in which the transferee is permitted to operate;

(2) A right to participate in a continuing manner in the commercial or economic activities of the transferred interest, e.g., sales promotion, sales and management or employee training, national meetings, etc.; and

(3) Any other right which permits the transferor to exercise continuing, active, and operational control over the transferee's business.[171]

Although Section 1253 was designed primarily to meet judicial difficulties in dealing with transfers of commercial franchises [172] the statute also has a significant impact on the status of prior law relating to the tax effects of the retention of certain interests by the transferor of a trademark. At a minimum it overrules the holdings of cases such as *Seattle Brewing & Malting Co.* which permitted a trademark transferor to control the quality of the product produced by the transferee and marked with a trade name without precluding capital gain treatment. Additionally, however, the statutory phrase "but is not limited to" used in connection with the enumeration of significant retained rights in Section 1253(b)(2) as well as the sweeping language of the proposed regulations pertaining to continual, active, and operational control by the transferor over the transferee's business suggests an extensive potential scope of Section 1253 application to trademark transfers. As Section 1253 application is dependent on factual criteria which are difficult to substantiate, trademark transferors who retain any interest in a transferred trademark and attempt to characterize the profit as capital gain may anticipate challenges regarding such treatment.

The proposed regulations incorporate an objective standard for contingent payments by providing that such payments will be considered to constitute a substantial element under a transfer agreement (thus precluding the entire profit under the agreement from possible capital gain treatment) if they are more than 50 percent of the total estimated amount.[173] Moreover, even if a contingency payment is not a "substantial element," so that the entire transaction is not thereby tainted, those amounts actually paid under a contingency arrangement are expressly treated as ordinary income under Section 1253(c).

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[171] Prop. Reg. § 1.1253-2(d).

[172] Note 170 at 160, *supra*.

[173] Prop. Reg. § 1.1253-2(d)(6).

Section 1245 applies to both tangible and intangible personal property.[199] As patents and copyrights are clearly intangible personal property subject to depreciation,[200] the statute applies to dispositions of such assets. On the other hand, trade secrets, trademarks, and other intangibles such as patent and copyright applications are not depreciable since they have indefinite life. The statute, therefore, does not apply to dispositions of such assets. Further, a taxpayer who elects to currently deduct instead of amortize research and experimental expenditures[201] will have a zero basis for patents resulting from such research—no depreciation and no excess depreciation to be recaptured upon disposition.

Section 1245 provides for the recapture of excess depreciation on all dispositions of Section 1245 property other than the following exempted dispositions which might involve either patents or copyrights: (1) gifts,[202] (2) transfers at death,[203] and (3) certain tax-free transactions involving corporations and partnerships.[204] Thus, the section applies not only to sales and exchanges, but to otherwise nontaxable dispositions, the most significant of which are corporate distributions to shareholders and corporate sales which are part of a plan of a twelve-month liquidation under Section 337.[205] Further,

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[199] Reg. § 1.1245-3(b).

[200] Reg. § 1.167(a)-3.

[201] See discussion ¶ 5.3 *infra.*

[202] I.R.C. § 1245(b)(1). However, a disposition of Section 1245 property by a person who could not take depreciation on the property is subject to Section 1245 application if the property was depreciated by a person who then made a gift of the property to the ultimate seller. (I.R.C. § 1245(a)(3); Reg. § 1.1245-3(a)(3).) Further, if a gift of Section 1245 property is made to charity, the charitable deduction is reduced by the amount that would have been recaptured as ordinary income had the property been sold. (I.R.C. § 170(e).)

[203] § 1245(b)(2). As the transferee at death receives a new basis equal to the fair market value of the property on the date of death (or on the alternate valuation date), he does not succeed to the decedent's potential recapture. Thus, a transfer on death permanently eliminates the potential recapture which has accrued up to the date of death. However, the transfer at death exception does not extend to gain, from a lifetime sale, that would be treated as income in respect of a decedent. I.R.C. § 691.

[204] There is no recapture on a tax-free corporate organization, corporate reorganization, liquidation of a controlled subsidiary corporation, contribution by a partner to a partnership, and pro rata distributions by a partnership to its partners. However, recapture income is recognized to the extent, if any, that gain would otherwise be recognized under other provisions of the Code, e.g., because of the receipt of both. In each instance the transferee succeeds to the transferor's potential recapture except to the extent that recapture income was recognized on the transfer. I.R.C. § 1245(b)(3), Reg. § 1.1245-4(c).

[205] Reg. § 1.1245-1(a)(1); Franklin Clayton, 52 T.C. 911 (1969).

¶ 1.4 THE HOLDING PERIOD REQUIREMENT

The general capital gain sections provide that the disposition of an asset will not qualify for long-term gain or loss treatment unless the seller has held the asset for a period of over six months.[180] The six-month period is ordinarily known as the holding period of the asset.

For purposes of determining the holding period of patents, the concept of "reduced to practice," a patent law term, has been incorporated in the tax law.[181] Under the above concept, with one exception, the holding period of a patent or unpatented invention begins with the date on which the original invention is reduced to actual practice.[182] The exception occurs where the patent is issued before the date the original invention was reduced to actual practice. As a patent is itself property, under such circumstances the date of issue of the patent governs the holding period.

It was determined that the holding period requirement was met where an invention was sold over six months after drawings of the invention were made. The drawings were substantially identical to those subsequently filed with the application upon which a patent was granted.[183] In another case, *Allied Chemical Corp. v. United States*,[184] the government unsuccessfully raised the contention that the bringing of an interference action in regard to an unpatented invention tolled the running of the period. The court found the contention was simply not borne out by the authorities since interference actions involve the question of which person was the first to reduce an invention to practice. Hence, reduction to practice clearly occurred regardless of the existence of an interference action.[185] On the other hand, the holding period was not satisfied by the preparation of test-tube samples of a product. Only after large batches were prepared and laboratory tests conducted to determine how well

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[180] I.R.C. §§ 1222, 1223, 1231(b).

[181] Allied Chem. Corp. v. United States, 66-1 U.S.T.C. ¶ 9212 (S.D.N.Y. 1966), *aff'd on other grounds* 370 F.2d 697 (2d Cir. 1967).

[182] Samuel E. Diescher, 36 B.T.A. 732 (1937), *aff'd* 110 F.2d 90 (3d Cir. 1940), *cert. denied* 310 U.S. 650 (1941), *acq.* 1938-1 C.B. 9. Prior to the decision in the *Diescher* case, the Internal Revenue Service had ruled that the holding period of an issued patent began on the date of issuance. I.T. 3112, 1937-2 C.B. 139, revoked by I.T. 3310, 1939-2 C.B. 190. After its acquiescence in the *Diescher* decision the ruling was revoked. G.C.M. 21507, 1937-2 C.B. 189.

[183] Herbert Allen, 11 T.C.M. 1093 (1952).

[184] Note 181 *supra.*

[185] See generally Walker, 1 *Patents* § 46 (2d ed. Deller 1964).

depreciable property is taxed as a capital gain. Section 1239 removes this tax advantage from sales or exchanges between specified related parties. Gain on the sale or exchange of depreciable property is characterized as ordinary income if the sale or exchange is, directly or indirectly,[209] between (1) husband and wife; or (2) an individual and a corporation, more than 80 percent in value of the outstanding stock of which is owned by such individual, his spouse, his minor children, and his minor grandchildren.[210]

For Section 1239 to apply, the property sold or exchanged must be depreciable in the hands of the transferee although it need not have been depreciable to the transferor.[211] As in the case of depreciation recapture, issued patents and copyrights clearly fall within the scope of Section 1239. Moreover, under certain circumstances patent and copyright applications may be subject to Section 1239 application. In *Estate of William F. Stahl v. Comm'r*,[212] the Seventh Circuit partially reversed a Tax Court holding that Section 1239 did not apply to the sale of patent applications. The appeals court viewed the patent applications upon which the taxpayer had received notice of allowability as having matured into patents, i.e., as depreciable property subject to Section 1239. The Tax Court subsequently adopted the above approach in *Lan Jen Chu*,[213] finding that patent applications had not sufficiently "matured" so that they could be treated as patents subject to depreciation for purposes of Section 1239.

Pursuant to Section 707(b)(2), ordinary income instead of capital gain is also realized where the property sold is depreciable property used in the trade or business of the transferee and the sale is:

(1) Between a partnership and a partner owning, directly or indirectly, more than 80 percent of the capital interests, or profits interests, in such a partnership; or

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[209] The Internal Revenue Service has given an expansive definition to the concept of an indirect sale. In Rev. Rul. 69-109, 1969-1 C.B. 202, the Service ruled that Section 1239 applied to a sale of a building from one corporation to another corporation where more than 80 percent of each corporation was owned by the same individual. However, the Tax Court has refused to follow the ruling, instead holding that a bona fide sale between two more than 80 percent controlled corporations was not an indirect sale by the controlling stockholder. 10-42 Corp., 55 T.C. 593 (1971), *nonacq.* 1972 P-H T.C. Memo. ¶ 55,298.

[210] I.R.C. § 1239(a).

[211] I.R.C. § 1239(b).

[212] 442 F.2d 324 (7th Cir. 1971), *aff'g and rev'g* 52 T.C. 591 (1961).

[213] 58 T.C. 598 (1972), *aff'd* 486 F.2d 696 (1st Cir. 1973).

copyrights. In *Richard W. TeLinde*[192] the taxpayer contracted in 1941 with a publisher to write a book which was then not yet in existence. The work on the manuscript was substantially completed in 1944. By 1945 mechanical operations such as typing, proofreading, and correcting the manuscript were finished. The court determined the taxpayer's holding period began not later than 1945 and probably earlier in 1944. The holding period was measured from the date the author had in his hands the completed work which he had contracted to deliver to the publisher.[193]

¶ 1.5 TAX AVOIDANCE AND BENEFIT PROVISIONS RESTRICTING CAPITAL GAIN TREATMENT

¶ 1.5a Recapture of Excessive Depreciation—Section 1245

[1] Background and Scope. In order to promote the modernization of plant and equipment, accelerated depreciation was first authorized by the Internal Revenue Code of 1954.[194] Taxpayers are permitted to use accelerated methods of depreciation for new real or personal property, including patents and copyrights, having a useful life of more than three years.[195] Under the accelerated methods, property may be depreciated at a rate up to two times the normal straight-line rate.[196]

The Treasury's long-standing dissatisfaction with capital gain treatment on the disposition of depreciable business property intensified by the potential tax abuse created by the accelerated depreciation methods, climaxed in its 1961 legislative recommendations which led to the addition of Section 1245 to the Code.[197] The intent of the statute is to recapture so-called excess depreciation by taxing gain on the disposition of depreciated property as ordinary income to the extent of depreciation taken after December 31, 1961, for dispositions after December 31, 1962.[198] A brief glance at the statute reveals an extensive scope.

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[192] Richard W. TeLinde, 18 T.C. 91 (1952).

[193] *Id.* at 95.

[194] I.R.C. (1939) § 117(a), (j) (now I.R.C. §§ 1221, 1231).

[195] I.R.C. § 167(c).

[196] I.R.C. § 167(b).

[197] P.L. 87-834, § 13(a) (Oct. 16, 1962), known as the Revenue Act of 1962, applicable to taxable years beginning after December 31, 1962.

[198] I.R.C. § 1245(a)(1). Note, gains and losses are not netted to determine whether or not gain is realized on Section 1245 dispositions.

were received near the end of the seventeenth year, the interest element escalates to $58,891.[217]

Moreover, the contingent nature of the amount to be realized precludes the licensor from electing the Section 453 installment method of reporting gain.[218] Generally, due to the contingent nature of the selling price, the Internal Revenue Service has permitted the taxpayer to treat the transaction as an "open transaction."[219] However, in most cases the licensor has a zero basis for the patent since expenses are normally claimed as current deductions under Section 174. Yet, Section 483 will apply to such a transaction despite the fact the licensor values the prospective royalties and reports the gain in the year of sale.[220]

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[217] See Reg. § 1.483-1(e)(3), Ex. 3, ascertainable fair market value and Ex. 5, contingent payments.

[218] Rev. Rul. 56-587, 1956-2 C.B. 303. The Treasury's position is that a contract must provide for the payment of fixed amounts at stated intervals to be eligible for the installment election.

[219] The "open transaction" doctrine originated in Burnet v. Logan, 283 U.S. 404 (1931). See Reg. § 1.1001-1(a); Reg. § 1.453-6(a)(2), and discussion ¶ 3.2 *infra.*

[220] Reg. § 1.483-1(e).

to prevent avoidance of Section 1245 by the sale or exchange of partnership interests in partnerships holding depreciable property, the Code treats the sale, exchange, or liquidation of an interest in a partnership as a disposition by the selling partner of his pro rata share of Section 1245 property owned by the partnership.[206]

[2] Measure of Recapture. Under the statnte, the maximum potential depreciation recapture upon disposition is all depreciation allowed after December 31, 1961, In the case of a sale, exchange, or involuntary conversion the depreciation recapture cannot, in any event, exceed the lower of the gain realized or the amount by which the recaptured basis exceeds the adjusted basis of the property.[207] Recomputed basis is the adjusted basis of the property at time of disposition plus an amount equal to all the depreciation deductions taken on the property since December 31, 1961.[208] Where property is disposed of other than by sale, exchange, or involuntary conversion (e.g., a dividend distribution by a corporation), the amount of depreciation recapture cannot exceed the amount by which the fair market value of the property exceeds its adjusted basis.

Example: Taxpayer purchased a patent for $15,000. During the period of his ownership he properly claimed $5,000 of depreciation and then sold the patent for $12,000. The amount of depreciation recapture could not exceed the $2,000 gain. On the other hand, if the taxpayer sold the patent for $18,000 the depreciation recapture could not exceed $5,000, the amount of previous depreciation deductions.

Example: Corporation *X* distributed to its shareholders, in liquidation, a patent with an adjusted basis of $100,000 and a fair market value of $150,000. Even though the corporation had claimed more than $50,000 of excess depreciation, the amount subject to recapture by the corporation could not exceed the $50,000 of appreciation over the adjusted basis.

¶ 1.5b Ineligible Sales of Depreciable Property to Related Parties

Related taxpayers may receive an advantage where depreciation deductions offset ordinary income and the gain from the sale of

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[206] I.R.C. §§ 751, 736(b)(2)(A).

[207] I.R.C. § 1245(a)(1)(A).

[208] I.R.C. § 1245(a)(2). Presumably, the taxpayer has reflected such depreciation on his records as reductions in the basis of the property, so this computation adds back to basis amounts previously deducted.

¶ 2.1 BACKGROUND

Prior to enactment of the Internal Revenue Code of 1954 there existed no specific Code provision governing the tax effects of patent transfers. Such transactions were controlled by the general capital gain provisions regardless of who owned the property right.[1] Yet, a serious controversy arose regarding the tax treatment with respect to payments received from the transfer of patents where the payments were both periodical and dependent on the extent of use of the patent over its life.[2] Judicial interpretations were for the most part favorable to taxpayers characterizing such payments as capital gain.[3] Nevertheless, the Internal Revenue Service continued to contend that periodic payments received for the use of a patent could not qualify for capital gain treatment for want of a "sale or exchange."[4]

The turning point for the taxpayer came in *Edward C. Myers*.[5] In *Myers*, the Tax Court held that an exclusive license to manufacture, use, and sell certain patent articles for the full term of the patent was a sale despite the fact the consideration was based on a percentage of annual sales. Shortly after the decision in the *Myers* case the Commissioner acquiesced to the holding.[6] Four years later, however, the Commissioner reinjected confusion in the area by withdrawing his acquiescence and substituting a nonacquiescence.[7] The opinion accompanying the nonacquiescence rejected the *Myers* decision stating that in future cases where the owner of a patent transfers rights in consideration for payments based on a percentage of sales, or in consideration of periodic payments over a period essentially coterminous with the life of the patent, such transfer was to be regarded for tax purposes as a provision for royalty payments, taxable as ordinary income.[8]

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[1] I.R.C. (1939) § 117.

[2] An additional, less important problem concerned the distinction between professional and amateur inventors. A professional inventor realized on the sale of patents since they were property held in the ordinary course of trade of business. An amateur inventor could realize capital gain on such sales. See, e.g., First Nat'l Bank v. United States, 138 F. Supp. 818 (D.N.J. 1955); Kronner v. United States, 110 F. Supp. 730 (Ct. Cl. 1953); Beach v. Shaughnessy, 126 F. Supp. 771 (N.D.N.Y. 1954).

[3] E.g., Comm'r v. Hopkinson, 126 F.2d 406 (2d Cir. 1942); Comm'r v. Celanese Corp., 140 F.2d 399 (D.C. Cir. 1944).

[4] Parke, Davis & Co., 31 B.T.A. 427 (1934); Julius E. Lilienfield, 35 B.T.A. 391 (1937); Claude Neon Lights, Inc., 35 B.T.A. 424 (1937); Comm'r v. Hopkinson, note 3 *supra*.

[5] 6 T.C. 258 (1946).

[6] 1946-1 C.B. 3.

[7] Mimeograph 6490, 1950-1 C.B. 7.

[8] *Id.* at 9.

(2) Between two partnerships in which the same persons own directly or indirectly, more than 80 percent of the capital interests or property interests.

In conclusion, as the following discussion of Section 1235 indicates, the above tax benefit provisions are inapplicable to a Section 1235 "holder" of a patent. Such holders are governed by a stricter capital gains statute, Section 1235(d), which disallows capital gain if a corporation is owned, 25 percent or more, directly or indirectly, by the transferee of the patent.[214]

¶ 1.5c The Imputed Interest Rules—Section 483

Possibly the greatest limitation to capital gain on the sale or exchange of intangible assets is the imputed interest provision—Section 483. The sole function of the rule is to prevent conversion of interest income into capital gain. The statute accomplishes its purpose by treating a portion of a contract sales price as interest where the contract calls for payments due more than one year after the sale or exchange.[215]

As the inherent speculative nature of intangible property, such as patents, copyrights, and know-how generally demands a selling price based on the life or productivity of the asset, it would seem the sale of such assets would not be subject to Section 483. Nevertheless, with the exception of Section 1235(a) patent transfers, Section 483 does apply to transfers of the above assets.[216] Hence, it is imperative the licensor be aware of this fact when negotiating licensing agreements, since the ultimate cost of Section 483 may be quite significant. For instance, assume a newly issued patent is transferred in a transaction which qualifies for capital gain under Section 1231. The consideration for the transfer is $100,000 annually over the seventeen-year life of the patent. Of the $100,000 received the first year, $4,819 would constitute imputed interest; if the same amount

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[214] See ¶ 2.4 *infra.*

[215] I.R.C. § 483(c)(1). The imputed interest rule applies to payments made after 1963 on account of sales or exchanges of property made after June 30, 1963. [1964 Revenue Act § 224(d).]

[216] Sections 1253(a) and (b)(2)(f) preclude capital gain treatment on the post 1969 sale or exchange of a trademark if the payments for the transfer are contingent upon productivity or use. See discussion ¶ 1.3e *supra.* For an analysis of the Section 1235(a) exemption, found in Section 483(f)(4), see ¶ 2.6d *infra.*

¶ 2.3 THE PROPERTY TRANSFERRED

¶ 2.3a Property Covered

The Regulations provide that Section 1235 extends to United States patents and foreign patents granting rights similar to a United States patent.[16] In conformance with legislative history the Regulations also recognize that "it is not necessary that the patent or patent application for the invention be in existence at the time of the transfer."[17]

Where a Section 1235 transferor in a basic patent transfer agreement undertakes a post transfer obligation, such as the assignment of future related inventions and patents, the Treasury has contended that Section 1235 is inapplicable.[18] In *Thomas L. Fawick*,[19] however, the Tax Court, referring to non-Section 1235 precedent concerning future inventions and patents, rejected the Treasury's views. The court noted that although the Treasury's contentions might prevail where a basic transfer agreement covered only existing improvements, since in *Fawick* the agreement covered "any improvement thereon that be owned, controlled, or subject to licenses by (the transferor)," the agreement contemplated improvements to be made in the future.[20] Such improvments were therefore transferred in the basic patent transfer agreement. Hence, if properly structured a basic patent

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[16] Reg. § 1.1235-2(a). The initially proposed Regulations regarding Section 1235 excluded design patents. However, the limitation was omitted in the final Regulations. See Bailey, "The Inventor," N.Y.U. 15th Inst. on Fed. Tax. 285, 287 (1957).

[17] Reg. § 1.1235-2(a). The Senate Finance Committee report stated: "The section does not apply to a property right in an invention differing from the monopoly rights evidenced by a patent. However, since the inventor possesses an exclusive inchoate right to obtain a patent, he may transfer his interest, whatever it may be, in any subsequently issued patent before its issuance and before as well as after he had made application for such patent." S. Rep. No. 1622, 83rd Cong. 2d Sess. 438, 439 (1954). See also F.H. Philbrick, 27 T.C. 346 (1957); Estate of Milton P. Laurent, Sr., 34 T.C. 385 (1960); Max A. Burde, 43 T.C. (1964), *aff'd* 352 F.2d 995 (2d Cir. 1965); Elmo Meiners, 42 T.C. 653, 659 (1964).

[18] In the case of improvement patents, the Treasury argued Section 1235 did not apply since the improvement patent was not in existence nor had an application for snch a patent been prepared or filed at the date the agreement to transfer the basic patent was entered into. With respect to future inventions, Section 1235 treatment would be available only if an actual assignment was made. See Thomas L. Fawick, note 19 *infra* at 111, 113. In effect, the Treasury was striving for a highly technical reading of the Section 1235 "transfer" requirement.

[19] 52 T.C. 104 (1969), *rev'd* and *rem'd* on another issue, 436 F.2d 655 (6th Cir. 1971).

[20] *Id.* at 114.

CHAPTER 2

The Individual Inventor and Section 1235

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the "insubstantial rights" exception with respect to Section 1235 transfers.

For instance, where the right to use the patented article was not of any substantial value, a grant of royalties to manufacture and sell rivets in return for royalties qualified as a transfer of all substantial rights under the statute.[25] Further, a grant of the right to make, use, and lease oil well service tools transferred all substantial rights where the nature of the equipment and practices in the industry rendered the right to sell the tools insubstantial.[26] On the other hand, all substantial rights were not transferred where the retained right to sell was valuable.[27] Finally, in *Franz Martini*[28] the Tax Court found a transfer of all substantial rights lacking where a licensing agreement granted only the exclusive right in the United States to use and sell goods made in Japan which embody parts covered by the patents. Clearly, the agreement granted neither the right to manufacture in the United States the goods covered by the patent, nor did it grant the right to sell in the United States goods manufactured in the United States which were covered by the patents.[29]

[2] Duration of the Transfer. Both the courts[30] and the Treasury[31] agree that a grant for a period less than the remaining term of the patent does not constitute a transfer of all substantial rights. Similarly, a grant subject to the transferor's right to terminate at will does not meet the "all substantial rights" requirement.[32]

[3] Geographical and Field-of-Use Fragmentations. The Treasury Regulations, as currently amended, state that a sale of all substantial rights does not include grants which are limited either geographi-

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[25] Flanders v. United States, 172 F. Supp. 935 (N.D. Cal. 1957); see also William W. Taylor, P-H T.C. Mem. ¶ 70,325.

[26] Lawrence v. United States, 242 F.2d 542 (5th Cir. 1957); see also Storm v. United States, 243 F.2d 708 (5th Cir. 1957).

[27] Kirby v. United States, 297 F.2d 466 (5th Cir. 1961), *aff'g* 191 F. Supp. 571 (S.D. Tex. 1960); Lawrence v. United States, 252 F.2d 542 (5th Cir. 1957) is distinguished.

[28] 38 T.C. 168 (1962).

[29] *Id.* at 170.

[30] Jacques R. Milberg, 52 T.C. 315 (1969); Wilkerson v. United States, 435 F.2d 845 (3d Cir. 1970).

[31] Reg. § 1.1235-2(b)(1)(ii).

[32] Franz Martini, note 28 *supra* at 171; Arthur M. Young, 29 T.C. 850 (1958), *aff'd* 269 F.2d 89 (2d Cir. 1959); Reg. § 1.1235-2(b)(4).

In 1954 Congress enacted Section 1235 to end the confusion in the area and assure certain individual inventors[9] that receipts from the transfer of their inventions would be eligible for capital gains treatment even though the method of payment was in the form of periodic royalty payments. Also, Congress erased the distinction under prior law whereby amateur inventors could potentially receive capital gain treatment, but professional inventors could not.[10] Finally, the six-month holding period ordinarily required for long-term capital gain treatment was eliminated in the case of Section 1235 transfers.[11] Hence, if a patent transfer complies with the provisions of Section 1235, the transferor is assured of long-term capital gain even though: (1) he is a professional inventor or otherwise holds patents for sale in the ordinary course of business;[12] (2) his holding period does not exceed six months; and (3) the consideration is contingent on events such as the transferee's sales or use of the patent.

¶ 2.2 STRUCTURE OF SECTION 1235

Section 1235 is applicable only if the transfer of a patent meets the following requirements:

(1) The transfer must be of all substantial rights to a patent or an undivided interest in a part of all such rights;[13]

(2) The transferor must meet the statutory definition of a holder, i.e., he must be the individual whose efforts created the property transferred, or an individual, other than his employer or a "related person," who acquired an interest in the property before the invention was actually reduced to practice,[14] and,

(3) The transfer is not made to related persons.[15]

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[9] There is little discussion in the committee reports as to why Section 1235 was limited to individuals, except for the notation that by enactment of the statute Congress had "no intention of affecting the operation of existing law in those areas without its scope." See S. Rep. No. 1622, 83rd Cong., 2d Sess. 438 (1954).

[10] See discussion, note 2 *supra*.

[11] I.R.C. § 1235(a).

[12] Reg. § 1.1235-2(d)(3).

[13] I.R.C. § 1235(a).

[14] I.R.C. § 1235(b).

[15] I.R.C. § 1235(d).

years later in *Vincent B. Rodgers*[40] the Tax Court was faced with a consideration of the amended Regulations in relation to a geographical fragmentation. The court held that inasmuch as the Regulation was in direct conflict with existing law when it was adopted it was invalid. In so holding, the court also alluded to the issue of field-of-use fragmentation:

> "We think Section 1235 requires merely the transfer of 'property' and that the rights in such property to make, use and sell the patented invention be conveyed to the transferee. *We read therein no prohibition of a division of a patent into different fields of application . . . so long as all substantial rights to the patent so divided are granted.*"[41]

Consistent with its *Rodgers* holding, the Tax Court in *Thomas L. Fawick*[42] reaffirmed that a field-of-use limitation would not disqualify either a multiple- or single-invention patent transfer from capital gain treatment under Section 1235.[43] On appeal to the Sixth Circuit, however, the Tax Court decision was reversed in a rather strangely reasoned opinion.[44] The Sixth Circuit adopted a two-fold "all substantial rights" test.[45] Under the test the first determination to be made is whether there has been a transfer of all substantial rights to a patent. To make this determination the court looked to what the holder has left after the transfer; if he retains any substantial rights to the patent, then the test is not met. If the transferor meets the first test, then the court will look further at what was relinquished. In order to qualify under the Sixth Circuit's test, the taxpayer must transfer the entire monopoly right to the patent, that is, the right to exclude others from the use of the invention. To arrive at the above conclusion the court simply ignored the Senate Finance Committee's statement that prior existing law, with the limited exception relating to manner of payment, was to apply to Section 1235 transfers. Evi-

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[40] 51 T.C. 927 (1969).

[41] *Id.* at 930.

[42] 52 T.C. 104 (1969).

[43] In *Fawick*, the transferor had entered into a license agreement with an unrelated corporation whereby he transferred an exclusive license to make, use, and sell certain patents under the condition that the patents only be used for marine service. Fawick later transferred nonmarine rights to a related corporation. The Commissioner determined on the basis of Reg. § 1.1235-2(b)(11)-(iii) that the royalties for the marine license were ordinary income because a transfer within a specified field-of-use or within a trade or industry does not constitute a transfer of "all substantial rights" to a patent under Section 1235.

[44] 436 F.2d 655 (1971).

[45] *Id.* at 657–661.

transfer agreement can, without loss of Section 1235 status, assign or license improvements which may later come into existence.

Finally, the Eighth Circuit has indicated that the special rule for the transfer of rights to a patent does not apply to transfers of franchise rights to produce and market a product.[21]

¶ 2.3b Transfers of All Substantial Rights

The benefits of Section 1235 apply solely to a transfer of "all substantial rights" to a patent or an undivided interest in a patent which includes a part of all such rights.[22] Treasury Regulation 1.1235-2(b), which defines the term provides as follows:

> "The term 'all substantial rights to a patent' means all rights which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction."

In some respects, however, the courts have been far more liberal than the Treasury in construing the term "all substantial rights" for purposes of Section 1235. Discussed below is the effect of a retention of those rights which are frequently reserved in the commercial exploitation of a patent.

[1] Rights to Manufacture, Use, and Sell the Patented Article. Generally, a transfer of all substantial rights must include the exclusive rights to make, use, and sell the patented article. However, pre-Section 1235 case law developed an "insubstantial rights" exception whereby a right need not be expressly transferred if it has little or no economic value.[23] Apparently, the Regulations have incorporated the foregoing concept by providing that there is no sale of all substantial rights only if the transfer is limited to less than all the claims or inventions covered by the patent which exist and have value at the time of the transfer.[24] Judicial decisions have also recognized

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[21] United States v. Wernentin, 354 F.2d 757 (8th Cir. 1965).

[22] I.R.C. § 1235(a). The Regulations state that an individual interest is a fractional share in the entire patent, such as an undivided one-half interest. It is not an interest in a particular aspect of the patent, such as the use for a term less than the remaining life of the patent. Reg. § 1.1235-2(c); Rev. Rul. 59-175, 1959-1 C.B. 213.

[23] See discussion ¶ 1.3b[1] *supra*.

[24] Reg. § 1.1235-2(b)(1), amended by T.D. 6852, 1965-2 C.B. 289.

recent rejection of the Tax Court's position and its endorsement of *Fawick* in *Mros v. Comm'r*,[51] it is likely the Service may again change its position, possibly setting the stage for a Supreme Court test of the issue.

[4] Infringement Provisions. Infringement provisions generally concern two different problems. First, there is the case where the action is taken against the licensee. To meet such a contingency, a clause is generally inserted into the licensing agreement regarding the continuance of royalty payments and the defense of the action. Usually, the licensee requires that payment of royalties be deferred during pendency of the action. Additionally, the licensor is ordinarily required to defend or aid in the defense. Neither provision will disqualify a transaction as a sale under Section 1235.[52]

The second problem arises where there is an infringement by third parties. If the licensor reserves the right to prosecute, he may also desire to reserve legal title to the patent. While the 1954 Code and Regulations are silent with respect to retention of legal title by a Section 1235 transferor for such a purpose, prior case law has discussed some aspects of the problem. For instance, as previously noted, the courts have determined that retention of legal title alone, without beneficial ownership, if held for the interest of another, is without value and hence not the retention of a substantial right.[53] If the licensor retains numerous other rights, however, a retained right to sue has been held a factor to be considered in determining whether there is a sale.[54]

Where the licensor does not retain title to the transferred patent, the licensee may nevertheless insist on a licensing provision requiring both parties to act jointly in resisting patent infringement and fixing the manner in which damages recovered for infringement should be divided between them. In *Watson v. United States*[55] the court held

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[51] 74-1 U.S.T.C. ¶ 9350 (9th Cir. 1974).

[52] For example, in Watson v. United States, 222 F.2d 689 (10th Cir. 1955), the license agreement provided for the suspension of royalties should an infringement proceeding be instituted against the licensee, for the payment of the impounded royalties to the licensor if the litigation was successfully concluded, and for termination of the royalty obligations in the event the litigation was unsuccessfully concluded. The provision was held not to preclude a sale, since it did not reserve any property rights in the inventions.

[53] See footnotes accompanying ¶ 1.3b[1] *supra*. The issue is discussed in relation to Section 1235 in William S. Rouverol, 42 T.C. 186, 193–194 (1964); William W. Taylor, T.C. Memo. ¶ 70,325.

[54] See Oak Mfg. Co. v. United States, 301 F.2d 259, 262 (7th Cir. 1962).

[55] Note 52 *supra*.

cally [33] or to fields of use.[34] The basis for this view is the following statement from the report of the Senate Finance Committee:

> "By 'undivided interest' a part of each property right represented by the patent (constituting a fraction share of the whole patent) is meant (and not, for example, a lesser interest such as a right to income, or a license limited geographically, or a license which conveys some, but not all of the rights or uses covered by the patent).
>
> "The section does not detail precisely what constitutes the formal components of the sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent . . . should be transferred to the transferee for consideration. *This requirement recognizes the basic criteria of a 'sale or exchange' under existing law,* with the exception noted relating to contingent payments, which exception is justified in the patent area for 'holders' as herein defined." [35]

The initial litigation concerning Section 1235 geographical and field-of-use fragmentation, *William S. Rouverol,*[36] took place before the Regulations were amended. The Internal Revenue Service argued its case on the basis of prior existing case law, thus appearing to accept the Senate Finance Committee's statement in that regard as controlling for geographical and field-of-use fragmentation purposes.[37] The Tax Court responded by pointing out that since such fragmentations are not precluded under prior law, a sale is not precluded for Section 1235 purposes where a patent is separated geographically or by fields of use and the fragmented parts transferred to different transferees.[38]

Shortly after the *Rouverol* decision the Treasury promulgated T.D. 6852 [39] which amended the Section 1235 Regulations to their present form, effectively excluding grants of patents limited geographically or by field of use from Section 1235 applicability. A few

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[33] Reg. § 1.1235-2(b).

[34] Reg. § 1.1235-2(c).

[35] S. Rep. No. 1622, 83rd Cong., 2d Sess. 438, 440 (1954). Neither the House nor Senate Committee reports gave any direct consideration to geographical or field-of-use fragmentations under Section 1235.

[36] 42 T.C. 186 (1964) (government appeal to the 9th Circuit dismissed pursuant to stipulation December 11, 1964); *nonacq.* 1965-2 C.B. 7. In *Rouverol* the taxpayer owned the patent to a multiple ball transmission which he licensed subject to various geographical and field-of-use fragmentations.

[37] *Id.* at 192–194.

[38] *Id.*

[39] 1965-2 C.B. 491.

[6] Protection Against Contingencies. A retention of rights which the Regulations do not consider as substantial include a vendor's lien or other security interest and reservations in the nature of conditions subsequent, such as a forfeiture provision in case of nonperformance.[62] While the Regulations generally reflect prior law in the area, they deal only with forfeiture options on behalf of the transferor. In at least one Section 1235 case, however, the Internal Revenue Service unsuccessfully contended that a provision permitting a licensee to cancel the license without cause upon giving thirty days' written notice resulted in a transfer of less than all substantial rights.[63] Moreover, where the forfeiture provision gives the transferor the option to cancel, the courts have been less restrictive than the Internal Revenue Service in determining whether a sufficient condition subsequent exists to meet the Section 1235 "all substantial rights" test. Under prior law, retention of a substantial interest is unavoidable unless occurrence of the condition subsequent is the happening of an event which is beyond the control of the transferor (such as bankruptcy of the transferee).[64] Yet, in *William S. Rouverol,*[65] the Tax Court, relying on prior law as authority, held that a transferor's unrestricted right to cancel an agreement if at any time in his sole judgment the licensee's condition should be such as to endanger its ability to carry on its business and/or perform its obligations was a permissible condition subsequent which did not interfere with the passage of title to the patent property.[66] As the foregoing termination clause gives the transferor almost unfettered discretion to cancel the agreement at any time, it appears to be a significant expansion of the interpretation afforded the "condition subsequent" principle under prior law.

¶ 2.4 WHO QUALIFIES AS A "HOLDER" OF A PATENT OR INVENTION

The benefits of Section 1235 are restricted to transfers of patents and inventions by taxpayers who qualify as a "holder." A holder is defined in Section 1235(b) as a person who is either an inventor or a person who contributes financially to the development of the inven-

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[62] Reg. § 1.1235-2(b)(2)(ii).

[63] William S. Rouverol, 42 T.C. 186, 194 (1964).

[64] See cases cited ¶ 1.3b[1].

[65] Note 63 *supra.*

[66] *Id.* at 194.

dently, the court concluded the Committee's example concerning exclusive licenses to manufacture, sell, and use for the life of the patent was meant to be exclusive.

Clearly, the reasoning of the Sixth Circuit in *Fawick* was somewhat questionable.[46] Shortly thereafter, the Tax Court in *Donald C. MacDonald*[47] took strong issue with the Sixth Circuit's conclusions. In squarely reaffirming the validity of geographical and field-of-use limitations for purposes of Section 1235 transfers, it felt compelled to comment on the Sixth Circuit's holding:

> "[I]n view of the apparent, indeed gratuitous damage done to Rodgers by the [Sixth Circuit], and to our position that a patent is divisible at least in some ways, we think it is appropriate to discuss the *Fawick* case.
>
> "We think the opinion of the Court of Appeals is consistent with our view that 'transfer of all substantial rights in the patent' is equivalent to 'sale of the patent.' The issue in *Fawick* and *Rodgers* was whether there may be a sale of parts of a patent, and what shapes the parts may take. In *Rodgers* we held that a patent is divisible and salable geographically.
>
> "In *Fawick* we held that it was divisible and salable by fields of use. In deciding *Rodgers*, we thought it was well established that a patent could be divided into geographic parts. *Waterman v. MacKenzie*, 138 U.S. 252, 255 (1891); Ellis, Patent Assignments 65 (1955 ed.). In deciding *Fawick*, we relied upon our earlier decision in *William S. Rouverol*, 24 T.C. 186 (1964), wherein we cited cases approving the division and sale of patents by fields of use.
>
> "If 'the monopoly right granted by the patent is the right to exclude others from making, using, or selling the invention,' we see nothing inherently indivisible about such right."[48]

Possibly due in part to the continued strong position of the Tax Court concerning the permissibility of geographical and field-of-use fragmentation without loss of Section 1235 benefits,[49] the Internal Revenue Service has recently acquiesced in both the *Rodgers* and *MacDonald* decisions.[50] However, in light of the Ninth Circuit's

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[46] See Bischel, "Developments in patent transfers provide clues to capital gain via fragmentation," 36 J. Taxation 157 (1972); Gilbert & Weltmen, "Recent Developments in Capital Gain Licensing," 57 A.B.A.J. 621 (1971).

[47] 55 T.C. 840 (1971).

[48] *Id.* at 858, n. 2.

[49] See Albert A. Mros, P-H T.C. Mem. 71-543.

[50] 1973 I.R.B. No. 2 at 5 (MacDonald); 1973 I.R.B. No. 11 at 5 (Rodgers, acq. in result only).

that a financial backer acquired his interest before actual reduction to practice where he paid for the initial design and building of certain patented transmission and clutch devices since actual reduction to practice cannot occur before a completed device is tested.[75] By contrast, in *Lee v. United States*[76] it was determined that an inventor was not entitled to Section 1235 holder status on the interest in the invention purchased from his co-inventor because the purchase did not occur until after the invention had been manufactured and marketed.[77]

A financial backer who has acquired a patent interest qualifies for holder status only if the acquired interest is in all substantial rights making up the patent. A taxpayer, who for his financial assistance to the inventor, received from him a percentage interest not in the patent, but in royalties under an exclusive license agreement did not qualify as a holder. Therefore, his share of the royalties were taxed as ordinary income.[78]

¶ 2.4c Employer and Related Person Exclusions

As previously indicated, a holder is defined in Section 1235(b) as, inter alia, an individual who is neither the employer or the creator of the patent nor related to such creator within the meaning of Section 1235(d). Determination of whether an individual is an employer or related person is made at the time when the substantive rights as to the interest to be acquired and the time when the consideration in money or money's worth to be paid is definitely fixed. For example, an individual who is neither the employer nor the relative of the inventor may, prior to the actual reduction to practice of the invention, promise to pay a definite sum for an undivided one-

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[75] *Id.* at 658. The court pointed out that because the taxpayer had paid all the expenses incidental to the design and building of the basic transmission and of the prototypes of the improved transmission and clutch at a time when these devices were still under development, the interest which he acquired in them, in exchange for such payment, was *perforce* acquired prior to their actual reduction to practice since generally, actual, as opposed to construction, reduction cannot occur prior to successful testing of a completed device.

[76] 302 F. Supp. 945 (1969).

[77] Lee did not acquire his co-inventor's interest until May, 1959. The device had been reduced to actual practice and, in fact, manufactured and marketed in 1958. Thus, although Lee did qualify under Section 1235(b)(1) as a holder with respect to his own one-half interest in the invention, he could qualify as a financial backer under Section 1235(b)(1) as to the one-half interest purchased from his co-inventor. See also Clement O. Dennis, 57 T.C. 352 (1971).

[78] Wesley A. Newby, T.C. Memo. 1960-278, *aff'd* 309 F.2d 48 (7th Cir. 1962).

that such a provision did not preclude a sale for the reasons that it protected the property of the licensee in the patent and safeguarded the financial interest of the licensor in the continued payment of royalties.

Finally, it should be noted that under the Regulations compensatory payments, whether resulting from a settlement or an award for damages, growing out of a suit for patent infringement and relating to the period after a Section 1235 qualified transfer, are treated as being part of the transfer transaction to the extent the payments relate to the interest transferred.[56]

[5] Prohibitions Against Sublicensing and Subassignment. The Section 1235 Regulations state that retention by the transferor of the right to prohibit sublicensing or subassignment by the transferee "may or may not" preclude a transfer of all substantial rights "depending upon the circumstances of the whole transaction . . . ."[57] In the few instances in which the issue has been considered in relation to Section 1235 transfers, the courts have regarded prior case law as controlling.[58] Prior law provides that a retained right to prohibit subassignments is insubstantial since it in no way interferes with or derogates from the grant of property consisting of all substantial rights to the patents.[59] In a recent Section 1235 case, *William W. Taylor,*[60] the licensing agreement contained a provision preventing the transferee from assigning its license or sublicensing under it without the transferor's consent. The Tax Court found that under the circumstances of the case the transferor's retained power did not amount to a substantial right in the patented property. It did not interfere with the transferee's manufacture and distribution of the property and enabled the transferor only to veto proposed assignments, not to make assignments himself.[61]

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[56] Reg. § 1.1235-1(c)(1).

[57] Reg. § 1.1235-2(b)(3).

[58] William W. Taylor, P-H T.C. Mem. ¶ 70,325; Vincent B. Rodgers, 51 T.C. 927, 931–932 (1969).

[59] See Joe L. Schmitt, Jr., 30 T.C. 322 (1958). See also discussion ¶ 1.3b[1].

[60] Note 58 *supra.*

[61] As previously noted, subassignment and sublicensing prohibitions pertain to the patent itself and in no way interfere with the rights to manufacture, use, and sell the patented product. Hence, it would seem such a retention may not effect any retention of a property right. See discussion ¶ 1.3b[1].

of all substantial rights to a patent developed by the employee will produce long-term capital gain under Section 1235.[83]

In *Roland Chilton*[84] the taxpayer was hired as an engineer for abilities other than inventing. At Chilton's insistence, his employment contract granted his employer the right of first refusal to purchase any of his inventions (for a specified royalty based on sales which was in addition to his annual salary) within ninety days after the device has undergone a development test. If the employer failed to exercise its option the taxpayer was free to apply for a patent on such invention himself. Since the taxpayer, rather than his employer, owned the initial rights to any inventions which he might create, the Tax Court agreed that on the facts of the case Chilton was not hired to invent, thus payments to him for assignment of his inventions qualified for Section 1235 treatment.[85]

By contrast, in *William Tiffin Downs*[86] the taxpayer received set monthly payments for his efforts in designing an electric hospital bed under a contract which called for an assignment of all the rights to all inventions conceived and developed during his "employment." However, the basic concept for the electric bed had originated with a third party and been subsequently adopted by his employer. The evidence demonstrated that Downs was actually hired to reduce the prior concept to practical application. The monthly payments were not dependent upon the sale or use by the employer or any patent rights resulting from the taxpayer's efforts. Also, the taxpayer covenanted to assign all rights he might have in inventions developed by his efforts "without further consideration." Accordingly, the court concluded on the facts that Downs was employed "to invent a specific product" and that the payments received were compensation for services rendered, taxable as ordinary income.

(1948). In *Blum* it was held that an engineer received ordinary income when he received payments from his employer, even though he assigned to his employer his rights in several patent applications. The employment contract clearly stated that all patents would be assigned to the employer without compensation other than the agreed salary and sales commissions. Under these conditions, the court ruled the patents were property of the employer at the time of their inception.

[83] Roland Chilton, note 84 *infra*, Becker v. United States, 161 F. Supp. 333 (W.D. Pa. 1958); T.C. Hill, T.C. Memo. 1963-211.

[84] 40 T.C. 552 (1963), *acq.* 1964-1 C.B. (Pt. 1) 4.

[85] *Id.* at 562–3. See also Thomas H. McClain, 40 T.C. 841 (1963). There the employee was obligated to assign all his inventions to his employer. The Tax Court found the capital gain benefits of Section 1235 were not precluded to the employee for payments based on royalties received from licenses granted by the employer since the employee had not been hired to invent.

[86] 49 T.C. 533 (1968), *acq.* 1968-2 C.B. 2.

tion prior to its actual reduction to practice. However, employers of inventors and persons related to inventors are specifically excluded from possible "holder" status.[67]

¶ 2.4a Inventors

The statute states that a holder includes any person whose efforts created the property transferred.[68] Inventors or co-inventors both of whose efforts assisted in creating the property may qualify as holders under Section 1235(b)(1) since the Regulations interpret the term to include anyone who would qualify as the original and first inventor or joint inventor under the United States patent act.[69] Section 1235 holder status applies equally to nonresident aliens.[70] On the other hands, the Regulations specifically exclude a donee, distributee, or legatee of an inventor's patent from holder status.[71]

¶ 2.4b Financial Backers

As previously noted, the only other person included in the statutory definition of holder is an individual other than the inventor who contributes financially to the development of the invention. Such a person qualifies as a holder if he has acquired his interest in the patent or invention in exchange for consideration in money or money's worth, which is paid to the creator of the invention prior to its reduction to practice, and further provided of course that the individual is neither the employer of nor related to the inventor.[72]

Actual practice is defined by the Regulations as having the same meaning as it does under Section 102(g) of Title 35 of the United States Code. Generally, an invention is reduced to actual practice when it has been tested and operated successfully under operating conditions.[73] Hence, in *Elmo Meiners*[74] the Tax Court concluded

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[67] § 1235(b)(2)(A) and (B).

[68] § 1235(b)(1). As only individuals may qualify as holders under Section 1235, all corporations, partnerships, trusts, and estates are therefore barred from becoming holders. However, individual partners may qualify as holders. Under this rule an individual who is a partner in a partnership which acquires an interest in a patent before it is reduced to practice may qualify as a holder to the extent of his partnership share. Reg. § 1.1235-2(d)(2).

[69] Reg. § 1.1235-2(d)(i).

[70] Reg. § 1.1235-1(a).

[71] Reg. § 1.1235-1(a).

[72] I.R.C. § 1235(b)(2).

[73] Reg. § 1.1235-2(e).

[74] 42 T.C. 653 (1964) (government's appeal to the 7th Circuit dismissed pursuant to stipulation, March 10, 1965); *acq.* 1967-2 C.B. 3.

(3) A fiduciary of a trust of which the transferor is a grantor or beneficiary.

(4) An educational or charitable organization which is exempt from income tax and which is controlled by the transferor or his family.

Three examples illustrate the general application of the above rule concerning transfers to corporations: (1) If Y owns 20 percent of the outstanding stock of Corporation A, Corporation A is not a related person for the purposes of Section 1235; (2) If, however, Y owns 20 percent of Corporation A and his wife owns 6 percent, Corporation A is a related person; and (3) If Y owns 20 percent and his brother owns 20 percent of Corporation A, Corporation A is not a related person since under Section 1235(d) only stock owned by Y's spouse, parents, children, and grandchildren will be considered as constructively owned by Y.[91]

Where there are successive transfers of undivided interests in patents, application of Section 1235 to the resulting income will be determined separately with respect to each transfer. Thus, assume that X, a Section 1235 holder, owns one-half of a patent while Y, who does not qualify as a holder, owns the remaining one-half. The entire interest is transferred to Z. Subsequently, X acquires Y's interest in the rights to payment from Z. One-half of the payments received from Z (attributable to Y's interest) will not qualify as capital gain under Section 1235.[92]

267(b) the phrase '25 per cent or more' is to be substituted for the phrase 'more than 50 per cent' each time it appears."

The above change is effective for transfers occurring on or after September 3, 1958. Regs. § 1.1235-2(f)(3). It contrasts markedly with the 80 percent control of corporations under Section 1239 and 80 percent control of partnerships under Section 707 when gain results.

[91] One suggested means for employment of a controlled corporate entity as a patent transferee without loss of Section 1235 benefits is utilization of two classes of stock, voting and nouvoting. The statutory language provides that ownership of no more than 25 percent in *value* of the outstanding stock of a corporation will not constitute control. This enables a holder to retain control of a transferee corporation by way of the voting stock without owning the prohibited percentage in the total value of the ontstanding shares. See Bailey, "Disposition of Inventions," 19th N.Y.U. Inst. on Fed. Tax. 89 (1961). Yet, the foregoing planning device is likely of very limited significance since most inventors wish to share, directly or indirectly, in the fruits of their labor. Further, it should be remembered that voting rights will give added value to the voting stock, thus creating a difficult factual issue for the taxpayer if the valuation is challenged by the Internal Revenue Service. See, e.g., Richard J. Lee, 302 F. Supp. 945 (1969).

[92] Regs. § 1.1235-1(c)(3).

half interest. If subsequently, the individual becomes the employer of the inventor and pays him the sum decided upon, the employer can receive the benefits of Section 1235 on a subsequent sale of his interest.[79]

The Regulations provide that the term "related person" means one whose relationship to the creator of the invention at the time of the transfer is one described in the constructive ownership rules of Section 267(b) of the Internal Revenue Code, except that the term does not include a sister or brother.[80]

¶ 2.4d Transfers to Employers

Although an employer may not qualify as a holder, transfers to an employer by a creator of an invention or other Section 1235 holders will receive the benefits of Section 1235 if the consideration received by the employee is in return for a transfer to his employer of all substantial rights to an invention or patent. Hence, it is of paramount importance to determine whether payments received by a "holder" employee are compensation for services or in exchange for invention or patent rights.

The Regulations state that payments received by an employee as compensation for services rendered to his employer as not eligible for capital treatment under Section 1235 if the employee is required by an employment contract to transfer the rights to his inventions to his employer. However, whether payments received by an employee from his employer upon the transfer of all substantial rights to a patent are compensation for services rendered or consideration for the transfer (under the employment contract or otherwise) is a question of fact. In determining which is the case the Internal Revenue Service will give consideration both to the employment relationship and to whether the amount of the payments depends upon the production, sale, or use by, or the value to, the employer of the patent rights transferred by the employee.[81]

Judicial interpretations of the above Regulation have strongly stressed its employment relationship aspect to determine whether or not the employee was "hired to invent." Where the inventor was hired to invent, it is usually found that the inventions and patents were the property of the employer in the first place, and the inventor had no property he could convey.[82] If he was not hired to invent, a transfer

[79] Reg. § 1.1235-2(d)(1)(ii).

[80] Reg. § 1.1235-2(f).

[81] Reg. § 1.1235-1(c)(2).

[82] See Blum v. Comm'r, 183 F.2d 281 (3d Cir. 1950), *aff'g* 11 T.C. 101

the aggregate theory[95] of partnerships controlled and the sale must be considered a sale to the individual partners. However, the District Court concluded that the tax characteristics of payments received in 1955 and 1957 from the 1952 transfer are to be governed by the 1954 Code. As Section 707(a) provides that when a partner engages in a transaction with a partnership, the transaction should be considered as occurring between the partnership and one who is not a partner, the payments received by the taxpayers since enactment of the 1954 code were eligible for capital gain status under Section 1235.[96] The court's conclusion would appear to enable an inventor to achieve capital gain treatment upon the transfer of a patent to a partnership in which he has an 80 percent or less interest.[97]

In comparison, other courts which have considered the issue have either rejected or extended only modified approval to the foregoing view. For instance, the Tax Court dealt with the problem in *George N. Soffron*,[98] where four co-inventors-owners of a patented process sold it to their partnership for payments based on production under the patented process. The court began by looking to the Regulations concerning transferors which provide that a partnership cannot be a holder, but that individual partners may qualify as holders. Applying this reasoning to transferees, the court proceeded to hold that a transfer to a partnership in which the transferor or a related person is a partner is to be analyzed as a transfer to each partner, instead of the partnership entity. Viewed in this manner, there was no sale or exchange since each taxpayer owned exactly the same interest in the patent both before and after its transfer to the partnership. Hence, the transaction failed to qualify as a transfer of all substantial rights under Section 1235. The court then proceeded to apply to general partnership rules of Section 707. Under the constructive ownership rules of Section 707(b)(3) the taxpayers, as brothers, were each deemed to hold a 100 percent interest. As the ownership exceeded 80 percent in each instance[99] the amounts realized on the transfer constituted ordinary income.

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[95] The Third Circuit had held, under the 1939 Code, that a partnership was not separate from its partners and did not own property as an entity distinct from its partners. Randolph Products Co. v. Manning, 176 F.2d 190 (3d Cir. 1949).

[96] Note 94 *supra* at 210.

[97] Section 707 denies capital gain treatment on the sale of business property to a partnership by a partner who owns more than 80 percent of the capital or profits of the partnership.

[98] 35 T.C. 787 (1961).

[99] For purposes of Section 707, each held 25 percent directly and 75 percent indirectly as a result of the relationship attribution rules.

The cases have placed heavy emphasis on the "hired to invent" criteria, thus potentially reinjecting some of the unpredictability originally generated by "amateur or professional" inventor distinction under prior law. Yet, while no court has so stated, where an employer is willing to pay an employee a royalty in addition to his usual salary, it would not seem to be for services rendered, especially if the amount of such royalties is based on income from sales or licenses.

¶ 2.5 TRANSFERS TO RELATED PERSONS—SECTION 1235(d)

As previously noted, a related person is excluded from Section 1235 holder status. Additionally, however, Section 1235(d), the related persons provision, provides that Section 1235 capital gain status shall not be available to any direct or indirect transfer of an invention or patent between related persons. Disqualification of such transfers from Section 1235 applicability occurs even though the transferor is a holder and the transfer, if made to a nonrelated person would receive the benefits of Section 1235. Further, the exclusion applies regardless of the amount of consideration for the transfer. Thus, the conisderation may either be full and adequate in money or money's worth, or it may be partially or wholly by gift.[87] Ineligible transferees include: [88]

(1) Members of the transferor's family. Family includes the transferor's spouse, ancestors, and lineal descendants, except brothers and sisters.[89]

(2) A corporation in which the transferee owns more than 25 percent in value of the outstanding stock, directly or indirectly.[90]

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[87] Rev. Rul. 57-40, 1957-1 C.B. 226.

[88] I.R.C. §§ 1235(d), 267(b)(1), 267(c)(4).

[89] I.R.C. §§ 1235(d)(2). The section modifies Section 267(c)(4) which defines a family as including brothers and sisters for constructive ownership purposes.

[90] I.R.C. § 1235(d)(1). As originally enacted Section 1235(d) provided for 50 percent in value of outstanding stock to constitute control. The reduction to 25 percent was made by H. Rep. No. 775, 85th Cong., 1st Sess. 33 (1957):

"In view of the especially favorable nature of the capital gains treatment provided under section 1235, your committee believes that this 50 per cent test is too high, and that capital gains treatment on the sale by an inventor of his rights in a patent should not be available under this section in any case where he owns 25 per cent or more of the stock of the corporation. For that reason the bill provides that in applying the rules under section

The Second Circuit observed the possible loophole contained in Section 707 whereby individuals may achieve Section 1235 capital gains status on the transfer of patents to a controlled partnership if no single individual and related persons own more than 80 percent, even though the group owns most of the transferee partnership.[103] In the factual context of the *Burde* case, however, the court determined the activities of the inventor and the taxpayer-husbands constituted a joint venture, treated under tax law as a partnership.[104] Therefore, the transfer occurred between a partnership consisting of the inventor and the two husbands to a partnership in which they controlled more than an 80 percent interest.[105] On this basis, the Tax Court's ordinary income characterization of the transfer proceeds was affirmed.

In a concurring opinion, Judge Friendly agreed with the Tax Court and the Internal Revenue Service that the partnership entity should be disregarded completely in Section 1235 situations. "[T]reating the partnership as a collection of individuals is 'appropriate' for fulfilling the purpose of Section 1235(d) to prevent abuses from sales of patents within the same economic group."[106] As support the opinion cited a statement by the Conference Committee on the controlled partnership provisions of the 1954 Code which sanctioned the use of the aggregate rather than entity view of partnerships in appropriate cases.[107]

The approach of the Second Circuit in the *Burde* was essentially the same as the *Weller* court, i.e., to view Section 1235 in light of the principles of Section 707. However, the *Burde* decision resolved a question not dealt with in *Weller*, the effect of Section 707 on transfers of patents to controlled partnerships. In a subsequent case,

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[103] Section 707(b)(2)(A) precludes capital gains treatment for a transfer by a *single* partner and related persons who own more than 80 percent of the transferee partnership interest. Section 707(b)(2)(B) mandates the same result for a transfer between two partnerships under 80 percent common ownership. There is no provision in Section 707(b)(2) relating to a transfer by individuals who, as a group, own most of the transferee partnership, although no single individual and related persons own more than 80 percent. Thus, if the inventor and the two taxpayer-husbands could have successfully maintained that they were mere co-owners, they presumably might have escaped the controlled partnership provisions of Section 707(b)(2) thereby achieving capital gain treatment.

[104] See I.R.C. § 761.

[105] Under Sections 267(b)(1) and (c)(4), the interest in the transferee partnership owned by the wives was attributable to the husbands.

[106] 352 F.2d at 1004.

[107] H.R. Conf. Rep. No. 2543, 83rd Cong., 2d Sess. 59 (1954).

¶ 2.6 RELATIONSHIP OF SECTION 1235 TO OTHER INTERNAL REVENUE CODE PROVISIONS

¶ 2.6a Transfers to Partnerships—Section 707

The only regulatory authority dealing with the relationship of partnerships and Section 1235 concerns the partnership as a transferor. The regulations do not recognize a partnership as an individual who can qualify as a Section 1235 holder. However, since a partnership is merely a conduit, each member of a partnership who is an individual may qualify as a holder as to his share of the patent owned by the partnership.[93] Thus, if a partnership is composed only of individuals, and an inventor-partner uses partnership property in the development of his invention with the understanding that the patent when issued will be come partnership property, each of the inventor's partners will qualify for capital gain treatment. If the partnership were composed of individuals plus other taxpayers, each of the individuals' shares of income attributable to the transfer of all substantial rights to the patent will qualify for long-term capital gain treatment under Section 1235.

Although there is general agreement that the partnership entity should be disregarded for Section 1235 purposes where it is the transferor of a patent, a difficulty of interpretation arises where the transferee of a patent is a controlled partnership. The uncertainty involves the question of whether or not a partnership transferee should be considered a separate entity for Section 1235 purposes. Specifically, the issue is: Should the "aggregate" theory of partnerships embodied in the foregoing Section 1235 regulations concerning transferor partnerships or the entity concept of partnerships of Section 707, a more general Code provision relating the partnerships, determine the tax attributes to a partnership transferee in a Section 1235 transaction?

In *Weller v. Brownell*,[94] the taxpayer made a transfer of a patent to a partnership of which he and his wife were noncontrolling partners. Weller contended Section 707(a) should take precedence and, pursuant to the provision, the 1952 transfer of his patent to the limited partnership must be treated as a transfer to a separate entity and, therefore, the partnership would not come within the prohibited class of Section 1235(d) transferees. The government asserted that since the transfer occurred prior to the effective date of Section 707

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[93] Regs. § 1.1235-2(d)(2). George N. Soffron, 35 T.C. 787 (1961).
[94] 240 F. Supp. 201 (M.D. Pa. 1965).

ordinary income under the controlled partnership provisions of Section 707.

The position taken by the Internal Revenue in the *Soffron* and *Burde* cases is indicative of its view that the transfer of a patent to a partnership should be treated as a transfer to individual partners. Where such a position is taken on audit, taxpayers who are assessed deficiencies on royalties from partnerships in which they own 80 percent or less would be well advised to avoid litigation in the Tax Court.

¶ 2.6b Relationship to Other Capital Gains Provisions—Sections 1221 and 1231

Until the recent decision of the Tax Court in *Myron C. Poole*[109] it was assumed by the courts and the Commissioner that Section 1235 was not the exclusive route to capital gain treatment for an individual inventor who was unable to satisfy the requirements of Section 1235. In an early Tax Court decision, *Leonard Coplan*,[110] the taxpayer-inventor was clearly ineligible for the benefits of Section 1235 in view of the fact he sought capital gain treatment on the proceeds from the sale of a patent to a 100 percent controlled corporation. Neither the Commissioner nor the taxpayer made any argument that Section 1235 should apply or that the existence of the section foreclosed the taxpayer from seeking capital gains treatment under the general capital gain provisions. However, the Tax Court on its own initiative noted that the Internal Revenue Service could have argued that Section 1235 was the exclusive means by which an individual inventor could receive capital gains treatment and further that considerable support for such position could be found in the legislative history of the provision. The court did not rule on this question, however, instead deciding for the taxpayer on the ground that he had fulfilled the requirements for capital gains under the general provisions of the law.

Subsequent cases which considered the same issue also ruled that the general capital gains provisions were not precluded where the taxpayer was unable to meet the Section 1235 requirements.[111] Further, when the Regulations dealing with Section 1235 were issued

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[109] Note 114 *infra*.

[110] 28 T.C. 1189 (1957). The case actually involved Section 117(g) of the Internal Revenue Code of 1939, as amended, which is identical with Section 1235 of the 1954 Code.

[111] Herbert C. Johnson, 30 T.C. 675 (1958); Sheen v. United States, 167 F. Supp. 543 (E.D. Penn. 1958); George N. Soffron, 35 T.C. 787 (1961); Julian A. McDermott, 41 T.C. 50 (1963); James C. Hambrick, 43 T.C. 21 (1964). Several commentators have reached similar conclusions regarding the

In contrast to *Weller* where the taxpayer relied on the entity theory of Section 707 to bring the patent within the ambit of Section 1235, in the *Soffron* case the specific provisions of Section 1235 were found to be inapplicable before the more general provisions of Section 707 were applied. However, in a third case, *Burde v. Comm'r*,[100] the Second Circuit rejected the Tax Court's aggregation approach to transferee partnerships, but viewed the relevance of Section 707 in a different light than the *Weller* court.

There, subsequent to the successful development of the bath oil formula for Sardo, two financial backers and the creator transferred their interests in the formula to a partnership consisting of the creator and the wives of the financial backers. As consideration for the transfer the taxpayer-husbands received a royalty based on net sales of the formula. The Commissioner asserted that the transfer was between related persons and the royalty payments should therefore be taxed as ordinary income. Citing *Soffron* and the Regulations as authority, the Tax Court sustained the Commissioner's holding that a partnership can never be treated as an entity for purposes of Section 1235.

On appeal, the Second Circuit found the Tax Court's reliance on Regulation Section 1.1235(d)(2) to be misplaced. As a transferee of a patent which has been reduced to actual practice can never be a holder, the Regulation interpreting the statutory definition of holder has no relevance to a transferee partnership and nothing else in Section 1235 precludes treating the partnership as an entity. On the other hand, the court concluded that the test employed in Section 707 to determine when a partnership may be treated as an entity is highly relevant and perhaps controlling in an analysis of the same question arising under Section 1235. For Section 707 purposes, a *controlled* partnership is not treated as a separate entity, but instead as an aggregate of individuals. Inasmuch as the control provisions of Sections 707(b)(2) and 1235(d) were designed to accomplish the same purpose, they should be compatibly utilized in determining if a partnership is to be treated as an entity.[101] However, the court was careful to point out that the taxpayer need not necessarily satisfy both Sections 707 and 1235; rather it was suggested that "in determining whether a transaction qualifies under section 1235, it is appropriate to examine whether it filters through the Section 707 sieve."[102]

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[100] 43 T.C. 252 (1964), *aff'd on other grounds* 352 F.2d 995 (2d Cir. 1965), *cert. denied*, 383 U.S. 966 (1966).

[101] 352 F.2d at 999–1000.

[102] *Id.*

In Revenue Ruling 69-482 [117] the Internal Revenue Service declined to follow *Poole*, instead reaffirming the position taken in the regulation. There the Commissioner was requested to advise whether the mere fact that a patent transfer for contingent amounts does not qualify for capital gain treatment under Section 1235 prevents a holder from qualifying for such treatment under other provisions of the Code. The ruling concluded that, consistent with legislative history, capital gain treatment is available outside of Section 1235; therefore Regulation Section 1.1235-1(b) is valid. In support of the Commissioner's position the ruling quoted a statement from another portion of the Senate Finance Committee Report:

> "In enacting this section, for the specific purposes set forth in this report, your committee has no intention of affecting the operation of existing law in those areas without its scope. For example, the tax consequences of the sale of patents in years in which this section is inapplicable, or by individuals who fail to qualify as 'holders,' or by corporations, is to be governed by the provisions of existing law as if this section had not been enacted." [118]

Since the *Poole* decision only two judicial pronouncements, both by district courts, have directly considered the issue.[119] Both decisions assumed that Section 1235 is not the sole recourse of a holder for capital gain treatment if he transfers patent rights and receives periodical contingent payments as consideration. For instance, in *Thomson v. United States* [120] the taxpayer transferred substantially all his rights in certain patents to a wholly owned corporation in return for royalty type payments. Commenting on the *Poole* analysis the court stated:

> "It is difficult to resist the conclusion that the dictum in Poole is a valid reading of the statute's words, but the whole checkered and unfortunate history of this area of tax law counsels that it would be incautious to read section 1235 as intending a denial of capital gains treatment in all cases in which consideration takes the royalty form unless the taxpayer can qualify as a 'holder' and unless the transfer is to an unrelated person." [121]

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[117] 1969-2 C.B. 164.

[118] Note 115 *supra.*

[119] Thomson v. United States, 70-1 U.S.T.C. ¶ 9193 (E.D.N.Y. 1969); Lee v. United States, 302 F. Supp. (E.D. Wis. 1969).

[120] Note 119 *supra.*

[121] *Id.* at 82,800. The court referred to *Comm'r v. Brown*, 380 U.S. 563, 577, n. 8 (noting the continuing uncertainty of the Commissioner's position,

Martin F. Emory,[108] involving the inventor in *Burde,* the Tax Court, while giving credence to the *Burde* holding regarding the interpretation of Section 707, continued to maintain its view that the issue should be approached by first determining that Section 1235 is inapplicable to the transfer and then actually applying Section 707 to the transfer.

The substantive effects of the alternative approaches may be summarized as follows:

(1) Both the Tax Court and Second Circuit agree that a patent to a related partnership does not constitute a transfer of all substantial rights under Section 1235 if no economic change in the economic ownership of the patent has occurred.

Example: *X* and *Y*, joint inventors, sold their equally owned patent to their equally owned partnership. Under the view of both the Tax Court and Second Circuit, the transfer of all substantial rights was within the meaning of Section 1235.

(2) Where the ownership interests in a patent and uncontrolled transferee partnership are not substantially identical the Tax Court would apparently treat the transaction as a transfer to the individual partners. The Second Circuit should not disregard the partnership entity.

Example: Inventor, *X*, sold his wholly owned patent to a partnership in which he is a 60 percent partner and unrelated persons own the remaining 40 percent of the partnership interests. The Second Circuit would treat the transaction as a transfer of the entire patent to the partnership entity and therefore allow capital gains on all royalties from the partnership to the inventor. Although the Tax Court position is not entirely clear, under the aggregation theory it would apparently treat the transaction as a transfer of an undivided 40 percent of the royalties received by the inventor and it would qualify for capital gain treatment. The remaining 60 percent would be treated as ordinary income.

Example: Inventor, *X*, sold his wholly owned patent to a partnership in which *X*, his wife and son each own a 30 percent interest. The remaining 40 percent interest is owned by an unrelated person. Although reaching their conclusions by different means, both the Tax Court and Second Circuit would ultimately agree the resulting royalty payments would be characterized as

[108] 47 T.C. 710 (1967).

audit. Yet, the taxpayer should be mindful that the Commissioner has changed his position in the past regarding the application of Section 1235 and is certainly not precluded from such vascillations in the future. In light of *Poole*, a change could be made with the assurance that at least one forum, the Tax Court would uphold the validity of a regulatory revision.[126]

¶ 2.6c Transfers to Corporations—Sections 1239 and 351

As previously noted,[127] under Section 1239, gain on the sale or exchange of depreciable property is characterized as ordinary income if the sale or exchange is between an individual and a corporation of which more than 80 percent in value of the outstanding stock is owned by such individual, his spouse, minor children, and minor grandchildren.[128] Of course, by definition Section 1239 cannot apply to a Section 1235 transfer from an inventor to his more than 80 percent controlled corporation since a transfer to such a controlled corporation would be excluded from Section 1235 benefits under the related party provision in Section 1235(d).

In fact, Section 1235(d) would clearly seem to preclude Section 1235 benefits from inuring to any transfer by a holder of a patent to a 25 percent or more controlled corporation. However, in *Martin F. Emery*,[129] a taxpayer attempted to circumvent the Section 1235(d) related party restrictions by interposing a controlled partnership between the inventor and the ultimate transfer to a controlled corporation. Essentially, he asserted that (1) no actual transfer of his rights in the invention occurred until incorporation of the partnership, and (2) his transfer of all substantial rights at the time of incorporation qualified for capital gain under Section 1235. In response, the court pointed out that the initial transfer of the invention to the controlled partnership was not illusory for tax purposes. Thus, Section 707 was applicable (causing the entire proceeds to be characterized as ordinary income). Moreover, the opinion noted that, in any event, under Section 351 no gain or loss is recognized where, as in the instant case,

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[126] In such an event, an inventor-transferor would still be assured favorable treatment of income from a non-Section 1235 transfer of a patent if he received a lump-sum consideration. However, even if the tax effect of such a sale may be diminished by spreading the gain under the Section 453 installment sales or income-averaging provisions, the necessity of setting a fixed price for the transfer would, in most instances, substantially reduce planning flexibility.

[127] *See* ¶ 1.5b *supra*.

[128] I.R.C. § 1239(a)(2).

[129] 47 T.C. 710 (1967).

in 1957 they took the position that the section is to be disregarded in determining if there has been a sale or exchange of a capital asset in cases not specifically within its terms. Cited as examples of situations not covered by Section 1235 are transfers to a related person by a holder and transfers by a nonholder.[112]

Nevertheless, in *Myron C. Poole*[113] the Tax Court took a strong contrary position on the exclusiveness of Section 1235 where an inventor-transferor of a patent is concerned. In *Poole* the taxpayer was the inventor and holder of a patent on a window designed for use in mobile homes. He transferred his interest in the patent to a corporation in which he owned 50 percent of the stock.[114] The court rejected the taxpayer's initial contention that he was entitled to the benefits of Section 1235 by finding that while Poole in form controlled only 50 percent of the stock, in substance he controlled all of it. Poole alternatively argued he was entitled to capital gain provisions of the Code. In response to this argument the court determined that Section 1235 is the exclusive means by which a holder, as defined in that section, may obtain capital gain treatment on the transfer of a patent if the transaction is one described in Section 1235(a), i.e., where the payments for the patent are contingent upon the productivity, use, or disposition, or if they are payable periodically over a period generally coterminous with the transferee's use of the patent. The court supported its view on the basis of legislative history, specifically quoting a statement of the Senate Finance Committee:

> "It is the intention of your committee that, if the mode of payment is as described in subsection (a), the sale of a patent by any 'holder' must qualify under the section in order for such 'holder' to obtain capital gain treatment."[115]

Moreover, although recognizing that the Regulations suggest a different result, the *Poole* court concluded they were invalid if contrary to the legislative purpose.[116]

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exclusiveness of Section 1235. See Porter, "Capital Gains on Patents Without Benefit of Section 1235," 41 Taxes 800 (1963); Bailey, "The Inventor," 15th N.Y.U. Inst. on Fed. Taxation 285 (1957); Mann, "Summary of Prevailing Case Law on Tax Aspects of Sales or Exchange of Patent Rights," 40 Taxes 767 (1962).

[112] Reg. § 1.1235-1(b).

[113] 46 T.C. 392 (1966) *acq.* 1966-2 C.B. 6.

[114] Note, the transfer in *Poole* occurred prior to the 1958 amendment to Section 1235(d) which changed the exclusionary provision of Section 1235 from transfers to more than 50 percent controlled corporations to transfers to 25 percent or more controlled corporations.

[115] S. Rep. No. 1622, 83rd Cong., 2d Sess. 441 (1954).

[116] Note 113 *supra*, n. 7 at 404.

patent. After using the patent for three years, *X* sold the patent for $30,000. Of the total gain of $16,000 (excess of $30,000 sales price over the $14,000 adjusted basis), $3,000 would be treated as ordinary income under Section 1245 and $13,000 would be treated as capital gain under Section 1235.

An additional potential limitation on the benefits of Section 1235 is found in the imputed interest rules. The sole function of the Section 483 imputed interest rules is to prevent conversion of interest income into capital gains. The statute accomplishes its purpose by treating a portion of a contract sales price as interest where the contract calls for payments due more than one year after the sale or exchange.[134] However, in enacting Section 483, Congress specifically excluded transfers described in Section 1235(a) from its scope.[135]

Example: Inventor *X*, after actual reduction to practice of his invention, transfers an undivided 80 percent interest to *Y*. *X* and *Y* form a corporation in which *X* has a 20 percent interst and *Y* has an 80 percent interest. If the patent on the invention is subsequently sold to the corporation, Section 483 will apply to *Y*, but not to *X* since his transfer is one described in Section 1235(a).

Nevertheless, in a revenue ruling[136] and recent Tax Court litigation,[137] the Internal Revenue Service has unsuccessfully attempted to narrowly construe the imputed interest exception for Section 1235(a) transfers by viewing the exception as available only if (1) the transfer is described in Section 1235(a), and (2) the transferor is entitled to capital gain under Section 1235. The most recent case, *Curtis T. Busse*,[138] concerned a taxpayer who had transferred his 50 percent interest in a patented invention to a related corporation. Although the transfer was described in Section 1235(a), the transaction was ultimately excluded from Section 1235 benefits via the Section 1235(d) related persons provision. However, it was evidently agreed (pursuant to Revenue Ruling 69-482) that the proceeds of the transfer were entitled to capital gain treatment under other Code provisions.

The court asserted its view that the Section 1235(d) limitations

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[134] I.R.C. § 483(c)(1).

[135] I.R.C. § 483(f)(4).

[136] Rev. Rul. 72-138, 1972-1 C.B. 140.

[137] Curtis T. Busse, 58 T.C. 389 (1972), *aff'd* 479 F.2d 1147 (7th Cir. 1973); Floyd G. Paxton, 53 T.C. 202 (1969), *nonacq.* 1971-2 C.B. 4.

[138] Note 137 *supra.*

Most recently in *Lan Jen Chu*[122] the Tax Court, although not required to rule on the issue of Section 1235 exclusiveness, appeared to suggest in a footnote that it continues to maintain the position expressed in *Poole.*[123] However, the effect of the court's decision was to permit a holder-inventor to characterize royalty payments received from a controlled corporation on his transfer to it of a patent application as capital gain under the general capital gain provisions of the Code.

Without doubt, the conflicting views of the Tax Court and Internal Revenue Service regarding the exclusiveness of Section 1235 for inventor-transferors receiving royalty type payments places the taxpayer in somewhat of a dilemma as it would seem that both interpretations have some support in the legislative history. The problem is of particular significance in that it is often desirable to employ the corporate form of doing business to insure the success of any new invention.[124] It is further complicated by the fact that it is unlikely the effect of *Poole* may be avoided by having the patent issued in the name of a corporation or other legal entity since under the patent laws application for a patent must be made in the name of the original inventor.[125] Transfer of such a patent application to a controlled corporation will, of course, be subjected to the test of Section 1235 applicability for taxation purposes.

Currently, at least an inventor-transferor can comfortably rely on the Regulations and Revenue Ruling 69-482 for availability of the general capital gain provisions where a transfer does not meet the requirements of Section 1235. The lack of Tax Court litigation directed to the issue since the *Poole* decision would seem to indicate the Internal Revenue Service has favorably disposed of the issue on

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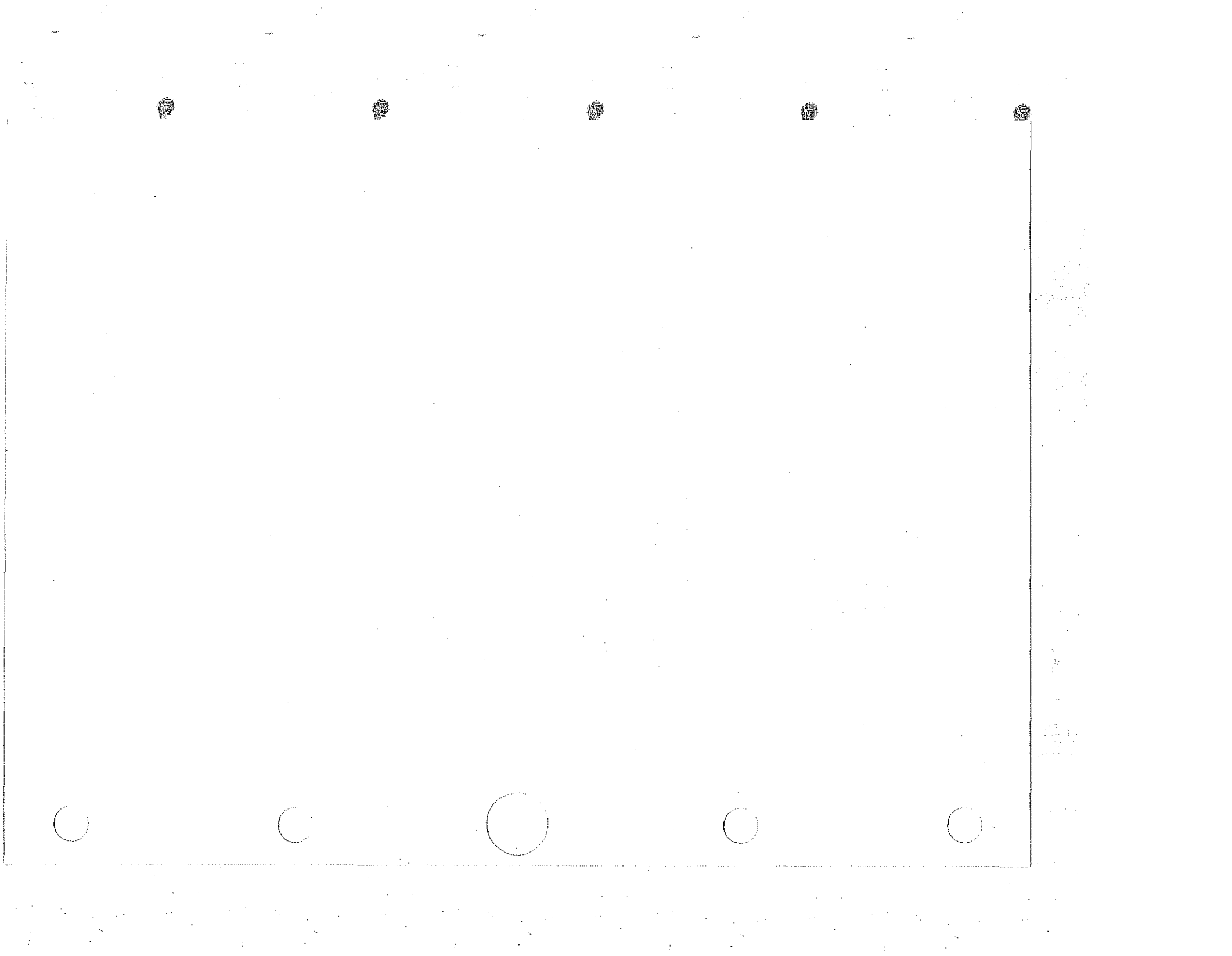
and doubt of the abstractly correct nature of a consideration measured by use of the patent right). For a recent analysis of the area see, Meyer & Hickey, "Taxation of Contingent Payments on the Sale of a Patent," 14 Idea 497 (1970).

[122] 58 T.C. 598 (1972), *aff'd* 486 F.2d 696 (1st Cir. 1973).

[123] *Id.* at 608, n. 1.

[124] The personal wishes of the individual inventor may make it desirable in many instances to limit the shareholders to members of the family, but under the provisions of Section 1235(d) the individual will be precluded from the benefits of that section on a transfer to a corporation in which he and related persons own 25 percent or more of the corporate stock. Additionally, under the *Poole* decision he will be precluded from receiving capital gains treatment on such transfer under the general provisions of the Code.

[125] 35 U.S.C. § 111 (1952). Where statutes permit the patent to issue in the name of an assignee [35 U.S.C. § 152 (1952)], the fact that the original application must be made in the name of the individual inventor would preclude the inventor-transferor from avoiding the effect of *Poole.*



the incorporators receive nothing except stock in return for the transfer of their interests in the partnership assets.[130]

On the other hand, it currently appears that a tax-wary inventor may be able to successfully tread his way through the web of Sections 1235(d) and 1239 to the safe ground of the general capital gains provisions of the Code. In *Lan Jen Chu*,[131] a case dealt with in the previous subsection, an inventor-holder made a transfer of certain patent applications to a controlled corporation. Evidently, the Internal Revenue Service agreed on audit that, although the transfer did not qualify for capital treatment under Section 1235 because of its exclusion under the related persons provision, in accord with its regulations the general capital gains provisions would be available were it not for the application of Section 1239. Moreover, the court ruled that Section 1239 (which applies only to depreciable property) does not encompass patent applications which had not sufficiently "matured" to be treated as depreciable patents. Hence, it would appear that a Section 1235 holder-inventor may transfer his invention or patent application to a controlled corporation without loss of capital gain characterization on the resulting royalty payments from the corporation if he is careful to make such transfer prior to the time mentioned above (i.e., before the time when official notification is received that the claim is allowable).[132]

¶ 2.6d Provisions Restricting Capital Gain—Sections 1245 and 483

As a patent used in a trade or business is depreciable property, it qualifies as Section 1245 property and therefore is subject to depreciation recapture when transferred, in spite of the favorable treatment accorded such transfer if it meets the requirements of Section 1235.[133] Accordingly, a portion of the gain otherwise qualifying as capital gain under Section 1235 may be recharacterized as ordinary income.

Example: Inventor *X* invested $17,000 in the development of a patent which he used in his business. He capitalized the costs and began to amortize them over the seventeen-year term of the

[130] *Id.* at 722. Note, however, in a more recent decision, Clement O. Dennis, 57 T.C. 352 (1971), *aff'd* 473 F.2d 274 (5th Cir. 1973), the Tax Court ruled that Section 1235 is not applicable to securities (i.e., boot) received in addition to stock since Section 1235 does not apply to any transaction qualifying under Section 351.

[131] Note 122 *supra*.

[132] See discussion in ¶ 1.5a[2] accompanying footnotes 211–212 *supra*.

[133] Reg. § 1.1245-6(a). Section 1245 overrides all other Code provisions including Section 1235.

method of reporting gain from casual sales of such property if the transfer meets the following criteria: [1]

(1) The property is not of a type normally included in inventory;

(2) The selling price exceeds $1,000; and

(3) The payments received in the taxable year of sale if any do not exceed 30 percent of the selling price. A 1969 amendment to Section 453 provides that evidences of indebtedness payable on demand and bonds, etc., in readily tradable form, are to be treated as part of the initial payment rather than indebtedness of the purchaser.[2]

Probably one of the least understood and unexpected difficulties for taxpayers adopting the installment method of reporting concerns the interrelationship of the 30 percent test and the Section 483 imputed interest rules. Interest payments are not regarded as part of the selling price for installment method reporting purposes where casual sales of personal property are concerned.[3] Thus, if an installment licensing agreement calls for precisely 30 percent down, but runs afoul of Section 483, under which interest is imputed, the selling price is reduced accordingly and as a result payments in the year of sale exceed 30 percent. Licensors adopting the installment method of reporting would be well advised to avoid risk of disqualification by either keeping payments in the year of sale as far below the 30 percent limit as possible or carefully computing the amount of the total sales price when the Section 483 imputed interest rules are applied to the transaction.

Furthermore, the installment election is simply not applicable to a licensor who wishes to exploit his idea via a transfer to a controlled corporation. In *Dennis v. Comm'r*,[4] the taxpayer Clement O. Dennis, in a transaction qualifying under Section 351, transferred his interest in certain patents to a controlled corporation in return for a promissory note payable in installments. As one of the alternative contentions for characterizing the resulting payments as capital gain, Dennis urged that the note was evidence of an installment sale.[5] In affirming

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[1] I.R.C. § 453(b)(1)(2).

[2] Pub. L. 91-172, § 412(a) (Dec. 30, 1969); known as the Tax Reform Act of 1969, applicable to sales after May 27, 1969.

[3] See discussions of imputed interest rules, ¶ 1.4c and ¶ 2.6d; Clark, "1964 Act: Imputed Interest Rules Have Unexpected Effects in Non-Related Areas," 20 J. Taxation 288 (1964).

[4] 57 T.C. 372 (1971), *aff'd* 473 F.2d 274 (5th Cir. 1973).

[5] The only other statutory provision which might conceivably have granted

were not intended to restrict the scope of the definitive or descriptive provisions found in subsections (a) and (b). Consequently, references to Section 1235(a) in other Code provisions, such as Section 483(f)(4), relate to *all* patent transfers made by holders, even if their transactions are not ultimately entitled to capital gain treatment under Section 1235.[139]

Unquestionably, the holding in *Busse* coupled with the view of the Internal Revenue Service that Section 1235 is not the exclusive means of obtaining capital gain treatment on transfers by holders [140] creates a valuable tax saving opportunity for the holder-inventor who wishes to employ a corporate entity as the vehicle to exploit his invention. Formation of a corporation in which the inventor has an 80 percent or less interest [141] followed by a sale of the invention or patent to the corporation will insure a return to the inventor of corporate royalty payments characterized solely as capital gain instead of ordinary income dividend distributions. Nevertheless, taxpayers should be made well aware that the Internal Revenue Service continues to maintain a different view toward such transactions and will likely challenge them. [142]

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[139] *Id.* at 395–397.

[140] See discussion ¶ 2.4 *supra.*

[141] Ownership of more than an 80 percent interest would convert the entire gain into ordinary income under Section 1239.

[142] The Tax Court's reasoning seems quite persuasive, especially in light of its affirmation by the Seventh Circuit. See note 137 *supra.*

CHAPTER 3

Income Spreading and Splitting

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¶ 3.1 INSTALLMENT SALES—SECTION 453

A taxpayer who meets the requirements of Section 453 is permitted to spread the income component of amounts received from the sale of intangible property over a number of tax accounting periods. The statute is applicable regardless of whether the gain is characterized as ordinary income or capital gain. However, a significant restriction on employment of the provision by licensors is its unavailability where payments are contingent upon such factors as sales, production, or sublicensing.

¶ 3.1a Basic Requirements

A transferor of intangible property may adopt the installment