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Dispositions of Inventions (Patented and Unpatented)

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sale situation, it is obvious that a taxpayer should not be able to affect
the character of his realized income merely by making a voluntary
election to defer the reporting of his gain. Where there is a tax-free
exchange, the deferment of the recognition of the gain (or loss) is auto-
matic and mandatory, not elective, and reflects a quite different statutory
pattern. In any event, clarification of the Service's position should be
sought before proceeding in this area of collapsible corporation problems.

XIII

CAPITAL GAINS PROBLEMS IN PARTICULAR AREAS (cont’d)

DISPOSITIONS OF INVENTIONS (PATENTED AND UNPATENTED)

Bruce Griswold

Another important source of capital gains is the sale of inventions
and similar items. In an economy which stresses growth and advance-
ment in technology, this type of transaction is of increasing importance.
In the last ten years, the sale of patents and "know-how" items has re-
ceived increasingly favorable tax treatment, both judicially and adminis-
tratively.

The general rules applicable to the sale or transfer of property of this
type, a review of the special statutory tax treatment provided for the sale
of patents, and an examination of certain related considerations, problems
and pitfalls involved in these transactions, will be discussed in this article.

GENERAL PRINCIPLES AND PROBLEMS DETERMINING WHETHER
 THERE IS "PROPERTY" (e.g., IS AN UNPATENTED INVENTION
 OR SECRET PROCESS "PROPERTY"?).

Section 1221 of the Internal Revenue Code defines a "capital asset"
as "property held by the taxpayer." Clearly, a patented invention consti-
tutes a property right, and therefore, meets the "property" requirement

1. See also Bailey, The Inventor, N.Y.U. 15TH INST. ON FED. TAX 285 (1957); Clark, Tax
Aspects of Operating Patents: Income from a License Agreement as Capital Gain or Ordinary
Income, PATENT LICENSING 91 (Practicing Law Institute 1958); Greenbaum, Tax Problems of
Authors and Inventors, N.Y.U. 13TH INST. ON FED. TAX 87 (1955); Taylor, How to Handle
Patents, Copyrights and Similar Interests, TAX IDEAS § 5012 (P-H 1959); Zarky, Capital
1959 Tax Inst. 357, 394.

of this section. However, there are a number of specific situations in this area in which the "property" requirement of section 1221 is not so clearly met.

One such situation arises in the area of unpatented items, such as, secret processes. The Government has claimed that the unpatented item is not the property of the taxpayer and, therefore, does not meet the definition of a capital asset. While there is not a great deal of authority on this problem, the lower courts have regularly ruled in favor of the taxpayer, holding that unpatented items and secret processes are entitled to capital gain treatment just as are patented inventions, and the Internal Revenue Service has acquiesced in many of these decisions. Further, the Tax Court has ruled that a taxpayer receives capital gain on the sale of an invention where the sale took place prior to the filing of the patent application as well as where the sale took place after the application had been filed. This same court has also accorded the same capital gain treatment to sales of inventions and secret processes that were never actually patented, at least in the United States.

Another parallel situation arises where an invention or secret process is unpatentable. It appears, in this area, that the courts make no distinction between a patentable item and an unpatentable one and afford the latter the same capital gain treatment as the former. As one district court has stated: "... one who discovers a secret process has certain rights in his discovery even though it may not be patentable."

A third situation concerns various business records and other "know-how" items. The Service itself has established clarity in this area by ruling that records regarding business, as well as intangible assets, such as goodwill, are capital assets (except where the records are, in fact, inventory). Further, the Service has recognized that the right to use manufacturing "know-how" is in the nature of a property right, treating income resulting from the licensing of such rights as royalty income under the particular circumstances.

4. See notes 5 and 6 infra.
7. See Nelson v. Commissioner, 203 F.2d 1, 6 (6th Cir. 1953).
DETERMINING WHETHER THE PROPERTY IS A "CAPITAL ASSET"

Once it has been determined that an item is property, the next question to be answered is whether that property constitutes a capital asset within the requirements of section 1221. The general rules governing this determination have been discussed previously. These general rules apply in this particular field, but are subject to certain amplifications and exceptions.

Except in special cases involving the sale of patents under section 1235, the character of the owner of the property is a vital factor in determining whether property is a capital asset. The definition of a capital asset in section 1221 specifically excludes a taxpayer's stock in trade, inventory and property held primarily for sales to customers in the ordinary course of business. Accordingly, sales of inventions by a professional inventor have been held to result in ordinary income. Whether or not an inventor is a professional or holds property as stock in trade or for sales to customers is, of course, a factual issue. The most important factors seem to be the number and extent of the taxpayer's prior sales and licenses of his patents, the relationship between the particular invention sold and the taxpayer's other inventing activities and his employment, and possibly the taxpayer's own characterization of his status. The Government has lost many of these cases, particularly where the inventor had some other principal activity or had not previously engaged in the sale or licensing of his inventions on a substantial scale.

The character of the property is also a factor in the tax treatment accorded to sales of this type of item. Section 1221 excludes from the definition of a capital asset property used in trade or business of a character which is subject to the allowance for depreciation. Patents are depreciable property and accordingly, are excluded from the definition under section 1221. However, section 1231 provides for capital gain treatment on the sale of depreciable property at a gain and accordingly, patents would be entitled to favorable treatment under section 1231 upon sale. Patent applications are also probably depreciable, at least under circumstances where the facts establish an appropriate measure for the

amount of the depreciation deduction (such as an annual payment measured by the return on the invention). 15

**Determining Whether There is a "Sale or Exchange"**

**Under Section 1221 and 1222 (or Section 1231)**

The general rules applicable to determining whether a transaction constitutes a sale or exchange have been discussed in a preceding section. 16 The discussion here is confined to a review of the problems encountered in connection with the transfer of intangible property, particularly patents. Transfers of patent interests have taken many varied forms covering all kinds of terms and provisions. The actual terms in a particular licensing or sales agreement and various unusual circumstances surrounding the transaction have presented problems in determining the exact nature of the transfer.

Three basic types of problems have arisen in the transfer of patent or similar interests. First, in many instances the transferor of a patent interest has retained administrative and security rights and in many cases has also retained commercial rights of great or speculative value. The retention of rights has, of course, led to the question: Does the particular transaction constitute a sale or something less than a sale? No general rule can be given as to the results in these cases since each one depends on the particular facts and the Government has, therefore, had varying degrees of success in its effort to obtain a decision that a given transaction was a license rather than a sale. Secondly, transfers have been made to corporations in which the transferor (and/or his family) had a substantial or controlling interest. The Government has contended that, because of the circumstances surrounding the disposition and the rights which the transferor had in the acquiring corporation, there was no sale. Here, however, the Government has been unsuccessful in its efforts to have the transfer held a license rather than a sale (assuming, of course, that the other criteria of a sale of a capital asset were present). Thirdly, sales of patents have been made on terms which did not set a specific purchase price for the patent. Rather, the return to the transferor was measured by sales of the patented article or the productivity of the patent. Here again, the Government has generally been unsuccessful. A more


detailed discussion of the problems in this field and of some of the representative cases gives some guideposts to the application of these rules.

Retention of Rights in Transferred Patent

In these cases involving a disposition of less than all the rights to a patent, the tax treatment will depend on whether the court finds that there was a license or a sale for tax purposes. In viewing a transaction or a series of related transactions, the court, pursuant to the well-recognized step-transaction doctrine, will examine all of the various agreements involved, including transfers of any rights back to the transferor, in order to determine what rights were retained and whether or not this retention precludes treatment of the transaction as a sale.17 However, the designation of a transfer as a license is not necessarily conclusive, since an exclusive license of the right to make, use and sell has been treated as an assignment of the patent and thus as a sale for tax as well as other purposes.18

Case law on this problem does not present a uniform pattern or provide rules for determining with any certainty the treatment of every particular arrangement. Even prior to the enactment of the special statutory provision on the sale of patents in the 1950's,19 there was case law to the effect that a sale took place where all substantial rights to a patent were transferred.20 Other cases held that the transferor had to transfer all three of the basic patent rights, i.e., the rights to make, use and sell, and transfer them to the transferee exclusively or the transfer was a license and did not convey the patent itself.21 Other cases by contrast permitted the seller to retain (or receive a license back for) certain valuable rights and the transaction was still treated as a sale with capital gain to the transferor.22

For convenience in analysis, the rights that have been retained in transactions of this type may be generally grouped into administrative rights and commercial rights. So far as the retention of administrative rights is concerned, the courts have generally treated a transfer as a sale even though the transferor retained the right to approve the licensing of

22. See notes 23-31 infra.
third parties,\textsuperscript{23} to veto the granting of sublicenses,\textsuperscript{24} or to terminate the agreement for breach of contract or insolvency on the part of the transferee.\textsuperscript{25} The Government has been quite unsuccessful in attempts to negate a sale where the transferor retained rights to protect his interest in the proceeds of sale.

In cases involving commercial rights, a division of the rights to manufacture, use and sell has occasionally been made (the transferor retaining or receiving back a license to manufacture, use or sell) and such a transaction has generally been treated as a sale.\textsuperscript{26} In certain of these cases the right that was retained was apparently of no significance to the parties as a matter of fact, while in other cases the right was probably valuable. In one case the patentee sold one of several inventions covered by a \textit{single} patent and received capital gain treatment.\textsuperscript{27} In other cases the transferor retained a right to terminate the agreement under certain circumstances, and this did not preclude capital gain treatment.\textsuperscript{28} However, where the rights of termination in the transferor have permitted him a more or less unlimited right to terminate prior to the expiration of the life of a patent, the transfer has been held not to be a sale.\textsuperscript{29} Further, a grant of rights which has been limited geographically has been considered as entitled to capital gain treatment.\textsuperscript{30} Likewise, the grant of rights to a patent where the grant was limited to a particular industry has received capital gain treatment, though in at least one instance, the patent involved was apparently of little or no value in any other industry.\textsuperscript{31} Caution should be exercised in this field as capital gain treatment in this type of transfer has been limited in at least one case to a situation where the

\begin{itemize}
\item \textsuperscript{23} Thompson v. Johnson, 50-2 U.S. Tax Cas. \textsuperscript{9428} (S.D.N.Y. 1950), \textit{aff'd}, 253 F.2d 43 (D.C. Cir. 1958).
\item \textsuperscript{24} Rollman v. Commissioner, 244 F.2d 634 (4th Cir. 1957).
\item \textsuperscript{25} Merck & Co. v. Smith, 261 F.2d 162 (3d Cir. 1958), \textit{affirming} 155 F. Supp. 843 (E.D. Pa. 1957).
\item \textsuperscript{26} Lawrence v. United States, 242 F.2d 542 (5th Cir. 1957) (transferor failed to transfer right to sell — sales not planned); Massey v. United States, 226 F.2d 724 (7th Cir. 1955); Lamar v. Granger, 99 F. Supp. 17 (W.D. Pa. 1951) (subsequent license back of right to use after three year interval); Evans v. Kavanaugh, 86 F. Supp. 535 (E.D. Mich. 1949), \textit{aff'd}, 188 F.2d 234 (6th Cir. 1951) (transferor retained the right to use invention and assign it to one other person); Arthur C. Ruge, 26 T.C. 138 (1956), \textit{acq.}, 1958-2 \textit{CUM. BULL. 6} (transferor retained right to use apparatus embodying invention in consulting work); Parke, Davis & Co., 31 B.T.A. 427 (1954), \textit{acq.}, XIV-1 \textit{CUM. BULL. 15} (1935) (transferor granted no right to sell). \textit{But cf.} Watkins v. United States, 252 F.2d 722 (2d Cir. 1958).
\item \textsuperscript{27} Merck & Co. v. Smith, 261 F.2d 162 (3d Cir. 1958), \textit{affirming} 155 F. Supp. 843 (E.D. Pa. 1957).
\item \textsuperscript{28} Roy J. Campayne, 26 T.C. 634 (1956), \textit{acq.}, 1958-2 \textit{CUM. BULL. 2}; Edward C. Myers, 6 T.C. 258, 265 (1946), \textit{acq.}, 1958-2 \textit{CUM. BULL. 6}.
\item \textsuperscript{29} Broderick v. Neale, 201 F.2d 621 (10th Cir. 1953); Lynne Gregg, 18 T.C. 291 (1952), \textit{aff'd per curiam}, 203 F.2d 954 (3d Cir. 1952), \textit{acq.}, 1952-2 \textit{CUM. BULL. 2}.
\item \textsuperscript{31} United States v. Carruthers, 219 F.2d 21 (9th Cir. 1955); First Nat'l Bank v. United States, 136 F. Supp. 818 (D.N.J. 1956).
\end{itemize}
rights in the industries retained were of little or highly speculative value.  

Sale to Related Corporation

Many cases have involved situations where the transferor has conveyed his patent interests to a corporation in which he or his family have substantial or controlling interests. The courts have generally sustained the taxpayer's position that such a transaction, if it meets the other requirements, does constitute the sale of a capital asset.  

In any transfer of this kind, the transferor must not forget the possible application of section 1239 to the sale and the consequent ordinary income treatment as a result of the sale if that statute applies.

Form of Payment for the Patent

The type of payment made for the transfer of the patent has been the source of much litigation in this area. Where the taxpayer is entitled to receive something other than a lump sum payment, the Government has argued that there has not been a sale. For many years it took the position that in effect the transferor was receiving royalties under a license and was not entitled to capital gain treatment. However, this position has shifted and presently the Service recognizes that the mere retention by the transferor of an interest resembling a royalty in a transaction which is otherwise a sale, does not prevent capital gain treatment for the transferor.

Determining the Holding Period

Determining the holding period of an invention presents certain problems. The general rule is that the holding period of an invention starts when it has been actually reduced to practice upon completion of a working pilot model. The holding period terminates upon the entry into a binding commitment for the transfer of the patent (even though

34. See Government's argument in these cases: Commissioner v. Celanese Corp., 140 F.2d 339 (D.C. Cir. 1944); Commissioner v. Hopkinson, 126 F.2d 406, 410 (2d Cir. 1942).
the actual payment or the transfer itself is postponed.36 Special problems arise in connection with the determination of the holding period of an employee-inventor who is required by his employment contract to assign any invention to his employer and the same problems are presented in connection with any form of agreement where the inventor is required to assign improvement patents.37

**SPECIAL STATUTORY RULES PROVIDING FOR CAPITAL GAIN TREATMENT UPON SALE OF A PATENT UNDER CERTAIN CIRCUMSTANCES**

Section 1235 was added to the Code in the 1950's to provide special treatment for the sale of a patent in cases where its provisions are applicable. It was intended to stimulate inventors and to encourage invention by granting favorable tax treatment both to inventors and to certain individuals who grant financial support to an inventor prior to the reduction of his invention to practice.

It should be emphasized that section 1235 does not provide an exclusive means for an individual to realize capital gain on the sale of a patent. Depending upon the facts, the transferor may find it more advantageous to attempt to work out a transaction meeting the rules discussed above rather than the requirements of section 1235. However, although section 1235 does not refer to the sale of intangibles other than patents and patent applications, its rules are more definite than those discussed above.

Section 1235 applies to the transfer: (a) of "all substantial rights" (b) to a patent (or an undivided interest therein) or (c) to a patent application by an individual inventor or by any other "holder" defined as an individual who is his financial backer (excluding the inventor's employer, any related party and, of course, any corporation).38 This section applies to a transfer even though the consideration for the conveyance is payable periodically over the period of use of the patent or is contingent upon the productivity, use or disposition of the patent, i.e., even though the payments resemble royalties, in effect. Thus, the statutory provisions have eliminated one of the primary tax problems which frequently arose in this type of transaction where the sale of a patent was made in return for a payment based on the productivity of the patent. The statutory pro-

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38. Quaere, does "patent" in INT. REV. CODE OF 1954, § 1235 include an invention (1) where patent is issued later? (2) which is never patented? (3) where patent application is dismissed or dropped? Treas. Reg. § 1.1235-2(a) states that "it is not necessary that the patent or patent application for the invention be in existence if the requirements of § 1235 are otherwise met." (Hereinafter cited as Reg.) See also S. REP. NO. 1622, 83d Cong., 2d Sess. 439 (1954).
visions have removed the possibility, as to qualifying transactions, that the Government can successfully claim a transaction is not a sale because the payments are so contingent.

Transfers to certain related persons do not come within the coverage of the statute and the definition of related person includes the spouse, ancestors and descendants of the inventor, as well as any corporation in which the interest of the inventor or his family is twenty-five per cent or more. Here again, the treatment of a transaction under section 1235 is in marked contrast to the treatment of transactions involving sales by an inventor to a related corporation under the case law discussed above. As has been stated, the courts have recognized as sales the transfer of a patent to a corporation in which the inventor and his family have held a substantial or controlling interest.\footnote{Cf. cases such as Leonard Coplan, 28 T.C. 1189 (1957), \textit{acq.}, 1958-2 \textsc{Cum. Bull.} 4 where there was a sale to family business \textit{outside} § 1235.} Under section 1235, this possibility is limited to a case where the inventor and his family own less than twenty-five per cent of the corporation's outstanding stock.

The provisions of section 1235 are also in striking contrast to the results under prior law in two other particulars. If the other requirements are met, section 1235 will apply to the transfer of a patent even though the inventor's holding period is less than six months, and even though the sale is by a professional inventor or by an individual who is in the business of buying and selling patents.\footnote{Reg. § 1.1235-2(d)(3).}

\textbf{Problem: What Are "All Substantial Rights"?}

One major problem under section 1235 arises out of the requirement that "all substantial rights" to a patent must be transferred if the transaction is to qualify under the section. As has been indicated, problems have arisen in an attempt to determine what constitutes a sale where the transferor has retained various rights. So far as section 1235 is concerned, the Regulations state that the words "all substantial rights" mean "all rights which are of value at the time the rights to the patent are transferred."\footnote{Reg. § 1.1235-2(b). See also summary set forth above in the discussion of case law and in S. \textsc{Rep. No.} 1622, 83rd Cong., 2d Sess. 439 (1954).} The Regulations give examples of what may be retained and what must not be retained. For example, the transferor ordinarily may retain administrative rights, such as nominal legal title to secure performance or payment of the amounts due.\footnote{Reg. § 1.1235-2(b)(2)(i).} He may retain a security interest, such as a vendor's lien or right to terminate the arrangement upon default by the transferee.\footnote{Reg. § 1.1235(b)(2)(ii).} So far as the retention of commercial
rights is concerned, the Regulations state that the transferor should not retain the right to terminate the license at will nor the sole right to sue for infringement. The license must be exclusive for the life of the patent or for its remaining term. Further, the Regulations state that the transferor, depending on the circumstances, may retain the right to use or sell the patent property but this right should certainly be exercised with extreme caution in view of the case law on this subject and the requirements that "all substantial rights" be transferred. It is probable that prior case law to the effect that the transferor may secure capital gain treatment upon the transfer of rights to a particular industry is applicable under section 1235, particularly if the retained rights are of no commercial value or are only of speculative value. Also, the existence of a shop right in an employer does not preclude the sale of "all substantial rights" by the employee.

Amounts received from the sale of an option to acquire a patent, if the transaction entered into in granting the license qualifies under section 1235, results in capital gain when the option is exercised and in ordinary income if and when the option lapses.

GAIN ON SALE OF DEPRECIABLE PROPERTY BETWEEN CERTAIN RELATED PARTIES IS ORDINARY INCOME

A 1951 amendment to the Code added an important provision which is of vital consideration in all transactions of this type as well as in many other transactions. Section 1239 now provides that any gain which is recognized upon the sale of depreciable property between certain related parties is treated as ordinary income. This rule has broad application to sales and exchanges of all kinds of depreciable property. Related parties are defined in this section as follows: "Husband and wife or an individual and a corporation where eighty per cent of the corporation's outstanding stock is owned by the seller, his spouse and his minor children and grandchildren." This section clearly seems to apply to the sale of a patent. Therefore, the provisions of section 1239 are an important limitation upon and a vital consideration in any sale or exchange of a

44. Reg. § 1.1235-2(b) (4); Arthur M. Young, 29 T.C. 850 (1958), aff'd, 269 F.2d 89 (2d Cir. 1959).
45. Reg. §§ 1.1235-2(b) (1), (c).
46. Reg. § 1.1235-2(b) (3) (i); Storm v. United States, 243 F.2d 708 (5th Cir. 1957).
47. United States v. Carruthers, 219 F.2d 21 (9th Cir. 1955); Estate of Milton P. Laurent, 34 T.C. No. 38 (May 31, 1960).
50. Kershaw v. United States, 180 F. Supp. 415 (Cr. Cl. 1960). This applies to patents. Royce Kershaw, 34 T.C. No. 44 (June 8, 1960) (same issue and same holding but as to different tax years).
patent (or any other depreciable property), by an individual to his spouse or to his controlled corporation. The disastrous consequences which the statute may bring upon a taxable incorporation, a taxable exchange, or a sale are illustrated by a recent Revenue Ruling and a recent Tax Court case.\(^{51}\)

**Related Problems Involving Possibility of Receipt of Ordinary Income Rather Than Capital Gain**

Very frequently, assets, such as patents, goodwill or other intangibles are sold and as part of the sale the seller gives the buyer a covenant that he will not compete with the buyer or agrees to perform personal services for the buyer. The distribution of the asset, coupled with such an agreement, presents the possibility that a portion of the amounts paid to the seller may be ordinary income on the ground that such payment was made for the covenant not to compete or for the agreement to perform services. This aspect of these transactions also has important tax consequences to the buyer, as well as to the seller, since the buyer will be entitled to a deduction for payments for services or for a covenant not to compete under certain conditions. An examination of the rules that have developed will help determine the treatment of any given transaction.

*Disposition of the Asset, Coupled with Covenant Not To Compete, When an Asset is Sold*

The tax treatment of the payments made to the seller will depend upon the fundamental nature of the transaction. The courts have held that a covenant not to compete, which is primarily to secure to the purchaser of an asset the beneficial enjoyment of the goodwill and is, in effect, a contributing element to the assets being purchased, is a non-severable part of the asset transferred and therefore, the payment for the covenant results in capital gain to the seller. Thus, in the sale of a newspaper business where the court found that the contract was not divisible even though a portion of the purchase price was allocated to the covenant, the seller was held entitled to capital gain since the price paid for the going business and intangibles associated with the business, included both control and the covenant not to compete.\(^{52}\) The buyer on the same facts was denied a deduction for payments for the covenant, again on the ground that it was not a severable transaction.\(^{53}\)


\(^{52}\) Toledo Newspaper Co., 2 T.C. 794 (1943), *aet*, 1944 CUM. BULL. 28. See also Ray H. Schulz, 34 T.C. No. 27 (May 19, 1960); Harry Shwartz, CCH TAX CT. REP. (CCH Tax Ct. Mem.) No. 288 (Oct. 27, 1960).

\(^{53}\) Toledo Blade Co., 11 T.C. 1079 (1948), *aff'd without opinion*, 180 F.2d 357 (6th Cir. 1950).
On the other hand, where the payment for the covenant not to compete is a severable and a separate item in the transaction, is specifically bargained for, has been evaluated and has stated consideration which is reasonable under the circumstances, payment for the covenant is ordinary income to the seller. Correspondingly, the buyer gets an amortization deduction for the amount paid for the covenant under these circumstances.

Disposition of the Asset, Coupled with Agreement to Perform Services

Frequently, the seller of the asset agrees to perform services after the sale has been completed. The nature of these services varies. Problems arise because the two transactions (the sale of the asset and the furnishing of services) are linked together and the Internal Revenue Service may allocate the consideration and payments differently than do the parties. For example, an inventor may be required to render services as part of the consideration for the assignment of the patent. He may not be able to prove that the payments made were for the sale of the patent and he may be required to allocate a portion of the payment he received to ordinary income for services.

The following summary gives the basis for distinguishing between those cases where the entire payment is treated as capital gain and those cases where some allocation is made to personal services. The entire payment is treated as payment for the capital asset where the services to be rendered are ancillary and subsidiary to the sale of the patent and of the type usually called for to implement the sale of a patent. On the other hand, where the services are to be rendered in making further developments and improvements in the field of the invention sold, the payment for services will be ordinary income.

The courts in each situation have reviewed the contract terms carefully to see if there is any allocation which can be inferred from the manner in which payments are handled. For example, a percentage payment which is reduced when the seller is no longer active in the business clearly indicates that the excess percentage payment was made in return for services, rather than for the purchase of the asset.

54. See also Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954); R. Ullman, 29 T.C. 129 (1957), aff'd, 264 F.2d 305 (2d Cir. 1959); G. H. Payne, 22 T.C. 526 (1954), acq., 1954-2 CUM. BULL. 5; A. Michaels, 12 T.C. 17 (1949), acq., 1949-1 CUM. BULL. 3.