



Case Western Reserve Law Review

Volume 17 | Issue 3

1966

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Recommended Citation

David R. Williams, *Capital Gains Treatment of Patent Transfers*, 17 W. Res. L. Rev. 844 (1966)

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NOTES

Capital Gains Treatment of Patent Transfers

THE INDIVIDUAL INVENTOR frequently finds himself at a serious disadvantage when attempting to exploit a patent on his own. Accordingly, he may choose to license or assign his rights in a patent to another individual or business which is more capable of utilizing the patent as a valuable income-producing item.

Gain realized from a license or an assignment of patent rights is taxable as income¹ but may be accorded beneficial treatment as long-term capital gain if the transaction falls within one of three categories. First, if a "holder" transfers, within the meaning of section 1235 of the Internal Revenue Code, all substantial rights or an undivided interest in a patent to anyone except a "related person," the transfer is considered the sale or exchange of a capital asset held for six months regardless of how long the patent has actually been held.² Second, if the patent qualifies as a capital asset within section 1221 and is held for six months prior to sale, the seller will receive capital gains treatment. To qualify as a capital asset, the patent must not be stock-in-trade, includable in inventory, held primarily for sale to customers in the ordinary course of business, or depreciable property used in a trade or business.³ Finally, if the patent constitutes property used in the taxpayer's trade or business within section 1231, capital gains treatment is also available. To qualify, the patent must be held for more than six months, be subject to depreciation under section 167, and not properly includable in inventory or held primarily for sale.⁴

It is the purpose of this Note to discuss the tax consequences of transfers to which the above rules are applicable. In the course

¹ INT. REV. CODE OF 1954, § 61(a) [hereinafter cited as CODE §].

² CODE § 1235. See 3B MERTENS, FEDERAL INCOME TAXATION §§ 22.134-137 (1958); Farber, *Capital Gains — "Transfer . . . of Property Consisting of All Substantial Rights to a Patent,"* 47 J. PAT. OFF. SOC'Y 981 (1965); Kurtz, *Distinctions Between License and Capital Transactions on Transfer of Patent*, N.Y.U. 23D INST. ON FED. TAX 135 (1965); Mann, *Capital Gains Treatment of Patent Transfers*, 44 J. PAT. OFF. SOC'Y 97 (1962); Mann, *Summary of Prevailing Case Law on Tax Aspects of Sales or Exchanges of Patent Rights*, 40 TAXES 767 (1962); Note, 36 N.Y.U.L. REV. 1010 (1961).

³ CODE §§ 1221, 1223. See 3B MERTENS, *op. cit. supra* note 2, § 22.133; Mann, *Capital Asset Status of Patents and Inventions Under General I.R.C. Sections 1221-1223*, 42 TAXES 317 (1964).

⁴ See, 3B MERTENS, *op. cit. supra* note 2, § 22.133; Porter, *Capital Gains on Patents Without Benefit of Section 1235*, 41 TAXES 800 (1963).

of this discussion, an attempt will be made to resolve the apparent inconsistencies in the treatment of transfers under section 1235 and transfers under either section 1221 or section 1231. In addition, the discussion will include a review of the interpretation and applicability of the various Code sections as developed by the Internal Revenue Service and the courts.

I. GENERAL REQUIREMENTS AND LIMITATIONS OF SECTION 1235

Section 1235 provides that a transfer (other than by gift, inheritance, or devise) of all substantial rights to a patent, or an undivided interest therein, by any holder, shall be considered the sale or exchange of a capital asset held for more than six months regardless of the fact that payments in consideration of such transfer might be payable periodically or be contingent upon the productivity, use, or disposition of the property transferred. Excepted from this general rule are transfers by nonholders and transfers to related persons.⁵

A. All Substantial Rights

There is no precise definition of what constitutes "all substantial rights" to a patent;⁶ rather, it is said that the circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, must be considered.⁷ Thus, the question of what is substantial is often considered to be factual,⁸ how-

⁵ Transactions involving these circumstances will be discussed in later sections. See text accompanying notes 57-64 *infra*.

⁶ The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent . . . should be transferred to the transferee for consideration. . . . It is the intention of your committee to continue this realistic test, whereby the 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. 1954 U.S. CODE CONG. & AD. NEWS 5082-83 discussing S. REP. NO. 1622, 83d Cong., 2d Sess. 439-40 (1954).

See, e.g., *Wing v. Commissioner*, 278 F.2d 656 (8th Cir. 1960).

⁷ Treas. Reg. § 1.1235-2(b) (1) (1957), as amended, T.D. 6852, 1965 INT. REV. BULL. NO. 44, at 9. [hereinafter cited as Reg. §].

⁸ *Lawrence v. United States*, 242 F.2d 542 (5th Cir. 1957), in which it is said: "What is 'substantial' often becomes a factual question to be decided according to the facts and circumstances of each case and the peculiarities inherent in each patent." *Id.* at 545.

ever, at least one court has held this determination to be a question of law.⁹

The Commissioner has defined "all substantial rights" to mean "all rights . . . which are of value at the time the rights to the patent . . . are transferred."¹⁰ The former treasury regulation containing this definition excluded grants which were limited in duration to less than the life of the patent. A recent amendment also excludes those grants of patent rights which are (1) limited geographically, (2) limited to certain fields of use, and (3) limited to less than all of the claims or inventions covered by the patent.¹¹ Apparently, the latter two categories of transfers are not excluded if they are grants of all rights which exist and have value at the time of the grant.¹² This would follow from a literal interpretation of the treasury regulations but will continue to be the subject of considerable controversy.

B. *Undivided Interest*

Long-term capital gains treatment is extended to the holder who transfers an undivided interest in part of the substantial rights to a patent. An undivided interest has been defined by the Commissioner to be "the same fractional share of each and every substantial right to the patent,"¹³ that is, a joint interest. In accord with the legislative history of section 1235,¹⁴ the Commissioner has taken the

⁹ The Fifth Circuit Court of Appeals in *Bannister v. United States*, 262 F.2d 175 (5th Cir. 1958), ruled: "It thus appears that the question decided below and to be decided here is not one of fact but of law. . . ." *Id.* at 176.

¹⁰ Reg. § 1.1235-2(b) (1) (1957), as amended, T.D. 6852, 1965 INT. REV. BULL. NO. 44, at 9 provides in part:

The term "all substantial rights to a patent" does not include a grant of rights to a patent —

- (i) Which is limited geographically within the country of issuance;
- (ii) Which is limited in duration by the terms of the agreement to a period less than the remaining life of the patent;
- (iii) Which grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; or
- (iv) Which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant.

¹¹ *Ibid.*

¹² *Ibid.*

¹³ Reg. § 1.1235-2(c) (1957).

¹⁴ "By 'undivided' a part of each property right represented by the patent (constituting a fractional 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 claims or uses covered by the patent)." S. REP. NO. 1622, 83d Cong., 2d Sess. 439 (1954).

position that a transfer of an undivided interest in a patent is not effectuated by a transfer of a right to income, a license which is limited geographically, a license which covers less than all valuable claims or uses, or a transfer which is limited in duration to a period less than the remaining life of the patent.¹⁵

C. *Qualifications of a Holder*

Section 1235 applies to any individual "whose efforts created the patent property and who would qualify as the 'original and first' inventor, or joint inventor"¹⁶ under the patent laws. Benefits are available as well to "any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention"¹⁷ provided that such individual is neither the employer of the creator nor related to the creator within the meaning of section 1235(d).¹⁸ It makes no difference that the creator or other qualified individual is in the business of making inventions or of buying and selling patents.¹⁹

Since section 1235 applies only to transferors who are individuals, a corporation cannot qualify as a holder. Also, the regulations clearly state that a partnership may not be a holder; however, "each member of a partnership who is an individual may qualify as a holder as to his share of a patent owned by the partnership."²⁰

¹⁵ Reg. § 1.1235-2(c) (1957).

¹⁶ Reg. § 1.1235-2(d) (1) (i) (1957), as amended, T.D. 6394, 1959-2 CUM. BULL. 186.

¹⁷ CODE § 1235(b). Regarding the requirement that consideration be given in money or money's worth, the Senate Finance Committee explained that money's worth means "consideration capable of present valuation in monetary terms. . . ." S. REP. NO. 1622, 83d Cong., 2d Sess. 440 (1954). See Elmo Meiners, 42 T.C. 653, 142 U.S.P.Q. 114 (1964) in which favorable treatment was extended to one who had purchased an invention before its reduction to practice.

As to the meaning of "reduction to practice," the treasury regulations provide that the term has the same meaning as under 35 U.S.C. § 102(g) (1964), and that "generally, an invention is reduced to actual practice when it has been tested and operated successfully under operating conditions." Reg. § 1.1235-2(e) (1957). For a detailed discussion of the term see 1 WALKER, PATENTS § 103 (Deller's ed. 1937) and cases cited therein.

¹⁸ This section incorporates the relationships of § 267(b) including the spouse, ancestors, lineal descendants, certain fiduciaries, and controlled corporations. Specifically excluded from the related party category are brothers and sisters who may become holders.

¹⁹ Reg. § 1.1235-2(d) (3) (1957), as amended, T.D. 6394, 1959-2 CUM. BULL. 186.

²⁰ Reg. § 1.1235-2(d) (2) (1957), as amended, T.D. 6394, 1959-2 CUM. BULL. 186.

II. FACTORS AFFECTING THE APPLICABILITY OF SECTION 1235

A. *Factors No Longer Controlling*

Certain provisions of a license agreement or assignment or the particular terminology therein may at first appear to be inconsistent with the nature of a capital transaction, thereby precluding the application of section 1235. However, the presence of only a few of these factors will have no controlling effect, whereas the presence of a number of these factors may be significant in reaching the ultimate conclusion that income from the transfer is to be treated as ordinary income rather than capital gain.

(1) *Mode of Payment.*—Payments made as considerations for the transfer of patent rights are most often in the form of royalties rather than lump sums. Since royalty payments appear inconsistent with the transfer of all substantial rights, a problem has arisen concerning whether these payments should be treated as capital gain. In the 1946 case of *Edward C. Meyers*,²¹ the Tax Court ruled that royalties measured by the amount of sales of patented products may be treated as capital gain. Subsequently, the Commissioner revoked his initial acquiescence in this decision.²² This nonacquiescence led to the enactment in 1954 of section 1235²³ and to the retroactive enactment in 1956 of section 117(q) of the 1939 Code.²⁴ Specifically, these sections provide that capital gains benefits may be obtained regardless of the fact that the consideration is payable periodically during the transferee's use of the patent or is otherwise contin-

²¹ 6 T.C. 258 (1946).

²² Initial acquiescence was reported in 1946-1 CUM. BULL. 3, and nonacquiescence was reported in Mimeograph 6490, 1950-1 CUM. BULL. 9.

²³ [I]n 1950 the prospect of continued litigation was engendered in this area by the issuance of Mimeograph 6490, 1950-1 CUM. BULL. 9, in which the Commissioner of Internal Revenue announced that he would thereafter regard such assignments or licenses as "providing for the payment of royalties taxable as ordinary income" if payment is measured by the production, sale, or use of the property transferred or if it is payable periodically over a period generally coterminous with the transferee's use of the patent. To obviate the uncertainty caused by this mimeograph and to provide an incentive to inventors to contribute to the welfare of the nation, your committee intends, in subsection (a), to give statutory assurance to certain patent holders that the sale of a patent (whether as an "assignment" or "exclusive license") shall not be deemed not to constitute a "sale or exchange" for tax purposes solely on account of the mode of payment. S. REP. NO. 1622, 83d Cong., 2d Sess. 439 (1954).

²⁴ See S. REP. NO. 1941, 84th Cong., 2d Sess. 11 (1956).

gent upon its productivity, use, or disposition.²⁵ Because of the manifest opposition of Congress and the courts,²⁶ the Commissioner finally acquiesced in *Meyers* in 1958.²⁷ Recently, the courts have had no difficulty in extending capital gains treatment under section 1235 to payments which were based on a "per unit" measure²⁸ or on monthly installments.²⁹

(2) *Use of the Terms "Licensed" and "Licensee."*—The traditional distinction between a license and an assignment³⁰ is no longer relevant to transfers which are otherwise within section 1235. Although the courts still discuss the distinctions between a license and an assignment in the income tax sense, the basic issue is whether all substantial rights in a patent have been transferred. The circumstances of the transaction rather than the particular terminology used in the instrument of transfer are now controlling.³¹ Thus, the use of the terms "license" and "licensee" should be no bar to a finding that all substantial rights have been transferred.

(3) *Conditions Subsequent.*—The legislative history of sections 1235 and 117(q) clearly indicates that capital gains treatment will be allowed despite the presence of clauses in the written agreement that rights to the particular patent will revert to the transferor on the occurrence of a condition subsequent.³² The courts have treated transfers as a sale or exchange where the agreement provided for termination upon default of a contract obligation by the transferee, upon bankruptcy or receivership of the transferee, or upon an

²⁵ CODE § 1235(a); Int. Rev. Code of 1939, § 117(q), ch. 464, 70 Stat. 404 (1956).

²⁶ Among numerous decisions in accord with *Meyers* are: *Watson v. United States*, 222 F.2d 689 (10th Cir. 1955); *United States v. Carruthers*, 219 F.2d 21 (9th Cir. 1955); *Allen v. Weiner*, 190 F.2d 840 (5th Cir. 1951); *Herbert C. Johnson*, 30 T.C. 675 (1958); *Leonard Coplan*, 28 T.C. 1189 (1957); *Roy J. Champayne*, 26 T.C. 634 (1956); *Kimble Glass Co.*, 9 T.C. 183 (1947).

²⁷ Rev. Rul. 353, 1958-2 CUM. BULL. 408.

²⁸ *Puschelberg v. United States*, 330 F.2d 56 (6th Cir. 1964).

²⁹ *McCullough v. Commissioner*, 326 F.2d 199 (9th Cir. 1964).

³⁰ This distinction is set forth in *Waterman v. Mackenzie*, 138 U.S. 252 (1891). For a discussion of the patent law distinctions between licenses and assignments see ELLIS, PATENT ASSIGNMENTS §§ 49-73 (3d ed. 1955).

³¹ Reg. § 1.1235-2(b) (1) (1957), as amended, T.D. 6852, 1965 INT. REV. BULL. No. 44, at 9; *Wing v. Commissioner*, 278 F.2d 656 (8th Cir. 1960).

³² "[R]etention by the transferor of rights in the property which are not of the nature of rights evidenced by the patent and which are not inconsistent with the passage of ownership, such as . . . a reservation in the nature of a condition subsequent (e.g., a forfeiture on account of non-performance) are not to be considered as such a retention as will defeat the applicability of this section." S. REP. NO. 1622, 83d Cong., 2d Sess. 440 (1954).

option of the transferee to terminate.³³ In addition, the regulations provide that a reservation in the nature of a condition subsequent may be retained by the holder,³⁴ since it will not be considered a substantial right for the purposes of section 1235. However, the retention by the holder of a right to terminate at will is substantial.³⁵

(4) *Retention of Title or of a Security Interest.*—The transferor will often wish to be assured of a sound financial position and therefore may retain legal title to the patent as security. With this in mind, the Senate Finance Committee expressed its desire not to require that title be transferred as a prerequisite to the transfer of "all substantial rights."³⁶ Accordingly, the regulations provide that the retention of legal title or of a security interest, such as a vendor's lien, will not be considered substantial.³⁷

(5) *Restriction on Alienation.*—For economic reasons, the transferor will necessarily be interested in the manner in which, and by whom, the patent will be used. Consequently, the transferor may impose certain restrictions upon the selection of subsequent transferees by the first transferee. Whether the presence of such restrictions will preclude capital gains benefits is uncertain since the regulations state only that it "may or may not be substantial, depending upon the circumstances of the whole transaction."³⁸ The point of departure seems to hinge upon the amount of control retained by the transferor over subsequent transferees.³⁹ Thus, if control exceeds an amount necessary to protect the transferor's economic interest, royalty payments might be treated as ordinary income.

³³ For a general discussion of conditions subsequent see *Magnus v. Commissioner*, 259 F.2d 893 (3d Cir. 1958), and cases cited therein.

³⁴ Reg. § 1.1235-2(b) (2) (ii) (1957).

³⁵ Reg. § 1.1235-2(b) (4) (1957). *But see* William S. Rouverol, 42 T.C. 186, 141 U.S.P.Q. 419 (1964), *nonacq.*, 1965 INT. REV. BULL. NO. 45, at 5.

³⁶ "The word 'title' is not employed because the retention of bare legal title in a transaction involving an exclusive license may not represent the retention of a substantial right in the patent property by the transferor." S. REP. NO. 1622, 83d Cong., 2d Sess. 439 (1954).

³⁷ Reg. § 1.1235-2(b) (2) (1957).

³⁸ Reg. § 1.1235-2(b) (3) (1957). It should be noted that this section applies only to the retention of an "absolute" right to prohibit sublicensing or subassignment. . . ." (Emphasis added.) *Quaere* as to the meaning of "absolute." See *Oak Mfg. Co. v. United States*, 301 F.2d 259 (7th Cir. 1962); *Watkins v. United States*, 252 F.2d 722 (2d Cir.), *cert. denied*, 357 U.S. 936 (1958). In both of these cases, the restriction upon further assignment or licensing of the patents was considered along with other factors to defeat capital gains treatment.

³⁹ See *Leubsdorf v. United States*, 164 F. Supp. 234 (Ct. Cl. 1958).

(6) *Obligation to Defend and Prosecute for Infringement.*—Agreements transferring patent rights often include provisions calling for the transferor's defense in or prosecution of infringement actions, for the joinder of the transferor in such actions, or for the indemnification of transferees for damages incurred in such actions. It has been said that provisions of this type may be analogized to the covenant to defend title, which is commonly used in conveyances of real estate.⁴⁰ Usually, the presence of these provisions in an agreement will not preclude capital gains benefits.⁴¹ Where both parties have the right to sue,⁴² or where the transferee may file suit in the transferor's name if he fails to sue,⁴³ favorable treatment may be had. Yet where the agreement contains other elements inconsistent with the transfer of "all substantial rights," capital gains treatment may be denied if the transferor expressly retains the right to sue.⁴⁴ Since the transfer of exclusive rights to a patent normally includes the right to sue, it is advisable that such right be transferred rather than retained.

B. *Factors Which May Preclude the Application of Section 1235*

There are a number of factors affecting patent transfers which may of themselves preclude beneficial treatment. Accordingly, one should be cautioned against their use unless the unfavorable results are justified by other business considerations.

(1) *Transferor's Option to Terminate.*—If the transferor retains an absolute option to terminate the transfer agreement, gain from the transaction will usually be treated as ordinary income.⁴⁵

⁴⁰ First Nat'l Bank v. United States, 136 F. Supp. 818, 822 (D.N.J. 1955).

⁴¹ *Ibid.* The court stated, "There is no inconsistency between the passage of title to a purchase of a patent and an obligation of the vendor to defend assaults upon the purchaser's title and to make good his damages, if any, arising out of use of the supposed rights conveyed." *Id.* at 822. See also *Watson v. United States*, 222 F.2d 689, 692 (10th Cir. 1955); *Golconda Corp.*, 29 T.C. 506 (1957).

⁴² *William S. Rouverol*, 42 T.C. 186, 141 U.S.P.Q. 419 (1964), *nonacq.*, 1965 INT. REV. BULL. NO. 45, at 5; *Thornton G. Graham*, 26 T.C. 730 (1956).

⁴³ *Magnus v. Commissioner*, 259 F.2d 893 (3d Cir. 1958).

⁴⁴ A typical case is *Oak Mfg. Co. v. United States*, 301 F.2d 259 (7th Cir. 1962), where the court held that "the right to control the prosecution of infringement suits was another item in the substantial 'bundle of sticks' retained by Oak which prevents the agreement from being considered a sale or transfer." *Id.* at 262. See also *Schmitt v. Commissioner*, 271 F.2d 301, 307 (9th Cir. 1959); *Watkins v. United States*, 252 F.2d 722, 725 (2d Cir.), *cert. denied*, 357 U.S. 936 (1958).

⁴⁵ Reg. § 1.1235-2(b) (4) (1957). In *Young v. Commissioner*, 269 F.2d 89 (2d Cir. 1959), the court held that capital gains benefits could not be sought under § 117(q) of the 1939 Code since the transferor had the right to terminate at his own discretion rather than upon the happening of a future event.

However, the Fifth Circuit has allowed capital gains treatment in just such a situa-

Ordinarily, beneficial treatment will be allowed where the transferee has the option to terminate at will.⁴⁶ In view of the detrimental tax consequences brought about by the transferor's right to terminate at will, it would be advantageous to phrase a termination provision in terms of the happening of some future event.⁴⁷

(2) *Geographical Restrictions*.—Regardless of whether there may be compelling economic reasons for restricting a transfer to a limited geographical area, the Commissioner has taken the position that such a restriction is inconsistent with the transfer of an "undivided interest."⁴⁸ Nevertheless, it may be inferred from the wording of the regulations that a geographically limited transfer may be consistent with the transfer of all substantial rights if it represents a transfer of "all rights which are of value at the time the rights to the patent . . . are transferred."⁴⁹ However, it is apparent that this view has not yet been tested in the courts.

(3) *Limitation to Certain Industries or Fields of Use*.—The regulations extend capital gains benefits to transfers limited to certain industries or fields of use if all valuable rights in the patent existing at the time of transfer have been transferred,⁵⁰ and the majority of courts have adhered to this rule.⁵¹ In 1964 the Tax Court

tion. Bannister v. United States, 262 F.2d 175 (5th Cir. 1958). The court of appeals reversed the lower court's "holding that because Bannister had the option to cancel on thirty days' notice the exclusive interest feature of the contract, this defeated the sale. On the contrary, we think it clear that, as stated by Judge Bratton in Watson v. United States . . . this reservation in no manner changed the fact that there was in fact and in law an effective sale, subject only to an optional condition which was never made effective." *Id.* at 178. However, one should be cautioned against reliance upon this decision since its holding apparently rests upon cases in which the transferee rather than the transferor was given the option to terminate.

⁴⁶ Lawrence v. United States, 242 F.2d 542 (5th Cir. 1957), in which the court held:

Appellant makes the further objection that the agreement could be terminated on the part of the licensee by giving thirty-days notice with or without cause, and on the part of the licensor by giving sixty-days notice upon default by the licensee. This court held . . . that the existence in the grantee of a right of cancellation does not preclude the idea of a sale, and that the possibility of termination by a licensor upon default of the licensee was a condition subsequent which did not negate the sale of the invention. *Id.* at 545.

⁴⁷ The right of the transferor to terminate on the happening of some future event is no bar to capital gains benefits. See text accompanying notes 32-35 *supra*.

⁴⁸ Reg. § 1.1235-2(c) (1957).

⁴⁹ Reg. § 1.1235-2(b) (1957), as amended, T.D. 6852, 1965 INT. REV. BULL. No. 44, at 9.

⁵⁰ Reg. § 1.1235-2(c) (1957).

⁵¹ In Puschelberg v. United States, 330 F.2d 56 (6th Cir. 1964), it was held that "all substantial rights" had been transferred where there was no other feasible use for the invention and there was no evidence that the rights retained by the transferor had

decided *William S. Rouverol*⁵² which greatly liberalized the concept of "all substantial rights." In that case it was held that, under section 1235, a patent may be separated into different fields of application, and that each field may be transferred to a different transferee with each transfer qualifying under section 1235. In effect, the court said that there may be a transfer of "all substantial rights" notwithstanding that all rights of value at the time of the transfer are not included in each transfer. Since this view represents an extreme departure from the regulations, it is likely that the Commissioner will continue to oppose similar treatment in this area.

(4) *Transfer of Less Than All Claims.*—The regulations provide that there must be a transfer of all the valuable claims to a patent as a prerequisite to the transfer of all substantial rights.⁵³ From the language of the regulations it may be inferred that a transfer of less than all claims of a patent may qualify for section 1235 benefits if all claims of value at the time of transfer are included in the transaction. In one case,⁵⁴ favorable treatment was extended to a transfer of less than all claims, since it had been stipulated by the parties that the species claims to the generic patent constituted separate inventions.

(5) *Duration Less Than the Remaining Life of the Patent.*—Most agreements transferring patent rights are drafted so as to remain in effect for the duration of the life of the patent rights transferred. Since the regulations specifically provide that a limitation upon the effective duration of the agreement to a term less than the remaining life of the patent is neither a transfer of all substantial rights⁵⁵ nor a transfer of an undivided interest,⁵⁶ it would be unwise for tax purposes to include such a restriction unless other business considerations would compel a contrary decision.

any ascertainable fair market value at the time of the transfer. In *Flanders v. United States*, 172 F. Supp. 935 (N.D. Cal. 1959), it was held that "all substantial rights" had been transferred where it was unknown whether the patented articles had any "established value" outside the aircraft industry at the time the original license was executed. In *Milton P. Laurent, Sr.*, 34 T.C. 385, 125 U.S.P.Q. 601 (1960), *nonacq.*, 1961-2 CUM. BULL. 6, it was held that "all substantial rights" had been transferred on the assumption that no other "substantial use" existed.

⁵² 42 T.C. 186, 141 U.S.P.Q. 419 (1964), *nonacq.*, 1965 INT. REV. BULL. NO. 45, at 5. Dictum in this case would indicate that a transfer limited geographically should also receive favorable treatment under § 1235.

⁵³ Reg. § 1.1235-2(c) (1957).

⁵⁴ *Merck & Co. v. Smith*, 261 F.2d 162 (3d Cir. 1958).

⁵⁵ Reg. § 1.1235-2(b) (1) (1957), as amended, T.D. 6852, 1965 INT. REV. BULL. NO. 44, at 9.

⁵⁶ Reg. § 1.1235(c) (1957).

C. *Specific Transactions Excluded From Section 1235 Benefits*

A number of transactions do not fall within section 1235 simply because of the nature of the particular transferee. Such a situation may arise where the individual inventor wishes to transfer patent rights to his employer or to a corporation.

(1) *Transfers From Employees to Employers.*—The employee-inventor will often enter into an employment contract whereby he is obligated to assign all patent rights to his employer. Where the employee receives a single consideration composed of compensation for services and for the obligation to assign patents, it will be difficult to establish that a particular sum has been received in return for the transfer of patent rights. In such a case, the entire consideration will be treated as ordinary income.⁵⁷ However, where compensation for the transfer of patent rights has been distinctly allocated among particular transactions, favorable treatment may be obtained.⁵⁸

At first glance the regulations would appear to bar favorable treatment to an employee who is required by contract to transfer his rights in an invention to his employer. If payments received by the employee are attributable to the transfer of all substantial rights in a patent, rather than to services rendered, section 1235 would apply.⁵⁹ This issue is regarded as a question of fact which may be decided on the basis of all of the facts and circumstances of employment, as well as whether the "amount of such payments depends upon the production, sale, or use by, or the value to, the employer of the patent rights transferred by the employee."⁶⁰ In recent cases decided by the Tax Court, the primary issue has been whether the employee was "hired to invent." When this question was answerable in the negative, capital gains benefits have been obtained.⁶¹ Whether or not the employer already has a "shop right" in the inventions is not considered to be of great significance.⁶²

⁵⁷ See, e.g., *Stout v. Commissioner*, 185 F.2d 854 (6th Cir. 1951); *Kleinschmidt v. United States*, 146 F. Supp. 253 (D. Mass. 1956); *Arthur C. Ruge*, 26 T.C. 138 (1956); *Arthur N. Blum*, 11 T.C. 101 (1948), *aff'd*, 183 F.2d 281 (3d Cir. 1950).

⁵⁸ E.g., *Hofferbert v. Briggs*, 178 F.2d 743 (4th Cir. 1949); *Pike v. United States*, 101 F. Supp. 100 (D. Conn. 1951); *William M. Kelly*, 16 P-H Tax Ct. Mem. 855 (1947).

⁵⁹ Reg. § 1.1235-1(c)(2) (1957).

⁶⁰ *Ibid.*

⁶¹ In *Thomas H. McClain*, 40 T.C. 841 (1963), McClain was employed by Lockheed and agreed to assign inventions relating to his employer's business. Subsequently, the employer announced that a percentage of income from the assigned patents would be paid to McClain. Such payments were treated as capital gain, the court relying upon

(2) *Transfers to Controlled Corporations.*—Because the inventor will have a continuing economic interest in his patent after its disposition and because of the various advantages available to a business adopting the corporate form, he may desire to transfer patent rights to a corporation in which he is a substantial shareholder. However, a transfer between an individual and a corporation in which the inventor owns twenty-five per cent or more of the outstanding stock is not a transfer to which section 1235 applies.⁶³ For this purpose the constructive ownership rules of section 267(c) apply, thereby attributing to the inventor ownership of stock held by certain family members or corporations, partnerships, or trusts in which he has an interest.⁶⁴ Accordingly, such situations should be avoided if capital gains treatment is desired.

III. TREATMENT UNDER SECTIONS 1221 AND 1231

There are a number of situations in which the advantages of

the fact that McClain was not "hired to invent" and that substantial sums were paid in consideration for the transfer of the patent. The case of T. Gardner, 32 P-H Tax Ct. Mem. 1199 (1963) involved another Lockheed employee. The court said:

It is of no consequence that the assignment was a condition precedent to employment, or required, or deemed effective at the moment the invention is conceived, or voluntarily made thereafter. . . . Where there is a transfer of all the patent rights, the only issue is whether the amounts paid are 'in consideration of such transfer' within the meaning of section 1235. . . . *Id.* at 1205.

In Roland Chilton, 40 T.C. 552 (1963), there was no patent reward plan for employees when Chilton was hired. At Chilton's request an employment contract was entered into under which Chilton's position was characterized as "Consulting Engineer" and his obligation was to assign inventions relating to aircraft products to his employer. The court emphasized that the crucial issue was whether Chilton was "hired to invent." Answering this in the negative, payments for the transfer of patents were accorded capital gains treatment. That Chilton was *required* to assign the patents was held to be immaterial.

The above cases are discussed in Delbaum, *Tax Court Brightens Capital Gains Possibilities for Employee-Inventors*, 19 J. TAXATION 306 (1963) in which the following conclusion was reached:

The Tax Court, at least, has little difficulty in finding the transfer and considers the key question to be whether the employee is hired to invent.

As pointed out earlier, none of these cases deals with the honoraria paid out, only with substantial payments. . . . It would appear that logically there should be no difference between large and small payments, yet a court would more likely find that payments of token size were not in consideration of the transfer but were additional compensation in the form of bonuses. *Id.* at 307.

For a discussion of employee compensation plans see, Farber, *Capital Gains-Transfer of Property Consisting of All Substantial Rights to a Patent*, 47 J. PAT. OFF. SOC'Y 981, 991-97 (1965); McTiernan, *Employee-Inventor Compensation Plans*, 46 J. PAT. OFF. SOC'Y 475 (1964).

⁶² Hans Jordan, 27 T.C. 265 (1956).

⁶³ Reg. § 1.1235-2(f)(3) (1957), as amended, T.D. 6394, 1959-2 CUM. BULL. 186. This applies to transfers subsequent to September 2, 1958.

⁶⁴ CODE § 1235(d).

section 1235 may not be available, such as where the transferor is not a "holder" or where the transferee is a "related person." Nevertheless, the regulations specifically provide that a transfer may still qualify for capital gains treatment under other provisions of the Internal Revenue Code and that section 1235 should be disregarded in determining whether the transfer constitutes the sale or exchange of a capital asset.⁶⁵ Whether the transfer of patent rights may qualify for favorable treatment under sections 1221 or 1231 depends on three major factors: (1) the nature of the asset; (2) whether the property has been held for six months; and (3) whether the transfer qualifies as a sale or exchange. It should be noted at the outset that depreciable property within the scope of section 1231 is excluded from treatment under section 1221. Yet both sections are similar in requiring that the transaction involve a sale or exchange of property held for six months.

A. *Nature of the Asset Under Section 1221*

Generally, to qualify as section 1221 property, the patent or invention must constitute a capital asset which is defined as property held by the taxpayer, whether or not connected with his trade or business, but excluding (1) stock-in-trade; (2) property held primarily for sale to customers in the ordinary course of a trade or business; or (3) property used in a trade or business subject to an allowance for depreciation under section 167.⁶⁶

The Commissioner most often applies the "frequency and continuity of sales" test to differentiate between capital and non-capital assets. In utilizing this test, it is argued that the transferor has previously sold or licensed other patents with such frequency and continuity that the disposition of the property at hand cannot be regarded as the transfer of a capital asset. Where the transferor is the inventor himself, the argument is made that he is a professional inventor engaged in the business of developing patents for sale.⁶⁷

The principal authority upon which the Commissioner has consistently relied is the case of *Harold T. Avery*,⁶⁸ in which the Tax Court found that an owner of twelve patents, who had previously sold three of the patents and had granted licenses on several of the

⁶⁵ Reg. § 1.1235-1(b) (1957).

⁶⁶ CODE §§ 1221(1), (2).

⁶⁷ *Harold T. Avery*, 47 B.T.A. 538, 541-42 (1942).

⁶⁸ *Ibid.*

others, held the patents primarily for sale to customers in the ordinary course of business. However, the courts have been reluctant to apply the doctrine of the *Avery* case except in a few subsequent decisions⁶⁹ where the facts clearly warranted such drastic treatment.

Conversely, one who has previously sold or licensed patents would not expect to be treated as a professional inventor if: (1) his principal activity is something other than developing patents;⁷⁰ (2) his inventing activities are "intermittent and irregular,"⁷¹ or (3) despite his status as a professional inventor, he has not licensed or sold a significant number of patents,⁷² or the patent in question is not within his limited field of activity.⁷³ Although there has been an apparent trend toward the liberal treatment of inventors, stricter application of the test should be expected against those who do not technically qualify as inventors.

One loophole that the professional inventor may take advantage of to avoid loss of capital gains treatment involves the situation in which he has licensed or assigned his patents to a corporation which he controls. The position has been taken that the corporation is not a "customer" if the transferor has a significant proprietary interest in the transferee.⁷⁴ With no previous history of licenses or sales which might preclude favorable treatment, subsequent sales may be made of property which still qualifies as a capital asset.

B. Nature of the Asset Under Section 1231

Despite the fact that property used in a trade or business and subject to an allowance for depreciation under section 167 does not qualify as a section 1221 "capital asset," it may nevertheless qualify for capital gains treatment under section 1231.⁷⁵ Whether a particular patent qualifies as a capital asset, or is held for sale to cus-

⁶⁹ Margaret L. Lockhart, 26 P-H Tax Ct. Mem. 402 (1957); Leo M. Harvey, 16 P-H Tax Ct. Mem. 271 (1947), *modified*, 171 F.2d 952 (9th Cir. 1949); Paul Smythe, Jr., 11 P-H Tax Ct. Mem. 927 (1942).

⁷⁰ Beach v. Shaughnessy, 126 F. Supp. 771, 775 (N.D.N.Y. 1954); Pike v. United States, 101 F. Supp. 100, 102-03 (D. Conn. 1951); Harold F. Silver, 15 CCH Tax Ct. Mem. 489, 498 (1956).

⁷¹ Harold F. Silver, 15 CCH Tax Ct. Mem. 489 (1956).

⁷² Evans v. Kavanagh, 86 F. Supp. 535 (E.D. Mich. 1949), *aff'd*, 188 F.2d 234 (9th Cir. 1951).

⁷³ First Nat'l Bank v. United States, 136 F. Supp. 818 (D.N.J. 1955). In this case, the inventor was considered a dealer in patents relating to optical goods but not a dealer in patents relating to tooth brushes.

⁷⁴ Harold F. Silver, 15 CCH Tax Ct. Mem. 489, 498 (1956).

⁷⁵ CODE § 1231(a).

tomers, or is depreciable property used in a trade or business often poses a difficult problem. Since these categories are mutually exclusive, one will rarely have a choice as to what section of the Code will apply. However, a particular patent may apparently qualify under both sections 1231 and 1235. If losses are anticipated, one might prefer to seek treatment under section 1231, since losses under this section are ordinary losses,⁷⁶ whereas section 1235 losses are capital losses.⁷⁷

C. *Holding Period*

For tax purposes, the period during which a person holds the rights to a patent begins with a reduction to practice.⁷⁸ Once the patent has qualified as a capital asset under section 1221 subject to the six-month holding period requirement of section 1222, or once the patent is considered section 1231 property subject to the six-month holding period requirement of that section, one must then determine whether the holding period requirement has in fact been satisfied.⁷⁹ This determination will in many instances begin with an analysis of what constitutes a reduction to practice.

There are various views on the nature of the activity constituting a reduction to practice so as to commence the running of the six-month period. The soundest view would appear to be that when there is an actual, as opposed to a constructive, reduction to practice, the period should commence. Generally, this occurs when the invention "has been tested and operated successfully under operating conditions."⁸⁰ Nevertheless, some courts have adopted the view that the six-month period commences sometime prior to an actual reduction to practice, such as when drawings have been completed which would enable a person skilled in the art to construct the invention.⁸¹ One court has expressed the view that the period commences when the inventor has "a completed conception of his invention and has . . . actually expressed it in the form of drawings

⁷⁶ *Ibid.*

⁷⁷ This conclusion is reached from the language of § 1235(a) that the transfer is considered "the sale or exchange of a capital asset."

⁷⁸ Carl G. Dreyman, 11 T.C. 153 (1948).

⁷⁹ CODE §§ 1222(3), 1231(a) both require that the property be held for six months to be entitled to long term capital gains treatment.

⁸⁰ Reg. § 1.1235-2(e) (1957), as amended, T.D. 6394, 1959-2 CUM. BULL. 186. Although this definition applies to § 1235, it is likely that it will be controlling as to other sections of the Code as well.

⁸¹ Edward C. Myers, 6 T.C. 258 (1946).

and a machine."⁸² In addition, "tacking" may be permitted so that the period during which the prior owner held the patent may be tacked on to the period during which the taxpayer holds the patent, if its acquisition was of such a nature that the taxpayer took the prior owner's cost basis as his own basis for the patent.⁸³

Generally, the holding period is considered to terminate upon formal execution of an assignment of the patent or invention.⁸⁴ However, it has been held that this period terminated prior to a formal execution of the assignment where it appears that the assignee has been given full control over the invention prior to the formal grant.⁸⁵

D. Sale or Exchange

The traditional test for determining whether the transfer of patent rights constituted a sale or exchange for purposes of sections 1221 and 1231 was whether the transfer was an assignment or license.⁸⁶ If the transfer was an assignment, the payments received were treated as capital gain.⁸⁷ In contrast, if merely a license was conferred, payments received by the transferor were treated as ordinary income.⁸⁸ In the case of *Waterman v. Mackenzie*,⁸⁹ the United States Supreme Court laid down the criteria for determining whether a particular transfer constituted an assignment or license, and this was controlling at least until section 1235 was adopted.⁹⁰ According to these criteria, an assignment was effectuated by transferring (1) an exclusive right under the whole patent, (2) an undivided part of that exclusive right, or (3) an exclusive right in the patent

⁸² Franklin S. Speicher, 28 T.C. 938, 945 (1957).

⁸³ CODB § 1223 (2).

⁸⁴ See Herbert Allen, 21 P-H Tax Ct. Mem. 977 (1952).

⁸⁵ Paul L. Kuzmick, 11 T.C. 288 (1948), *acq.*, 1949-1 CUM. BULL. 3.

⁸⁶ See ELLIS, PATENT ASSIGNMENTS §§ 49, 55 (3d ed. 1955).

⁸⁷ *E.g.*, Lamar v. Granger, 99 F. Supp. 17, 36 (W.D. Pa. 1951).

⁸⁸ *E.g.*, Broderick v. Neale, 201 F.2d 621 (10th Cir. 1953).

⁸⁹ 138 U.S. 252 (1891), in which the court set forth the traditional rule of an assignment as follows:

The monopoly thus granted is one entire thing, and cannot be divided into parts, except as authorized by those laws. 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, undivided part or share of that exclusive right; or, 3d, the exclusive right under the patent within and throughout a specified part of the United States. *Id.* at 255.

⁹⁰ The "substantial rights" test appears to be gaining recognition in section 1221 and 1231 cases.

within a specified part of the United States. Anything less than this was considered a mere license.

Presently, the law is not clear as to what constitutes a sale or exchange for the purposes of sections 1221 or 1231. Some courts apply the *Waterman* test,⁹¹ others the "substantial rights" test,⁹² and still others, a combination of the two.⁹³ Applying the substantial rights approach, the courts have recently permitted favorable treatment where the transfer has been limited geographically⁹⁴ or to certain uses or industries,⁹⁵ or to less than all claims of the patent.⁹⁶ Such a liberal trend in these areas would seem to indicate that similar treatment might also be available in cases governed by section 1235.

IV. ADVANTAGES AND DISADVANTAGES OF THE VARIOUS CATEGORIES OF TRANSFERS

The above analysis demonstrates that there are various advantages and disadvantages in characterizing a transfer as falling within either section 1235 or sections 1221 or 1231. The remainder of this discussion will be devoted to pointing out distinctions between the requirements of the various Code sections in order that capital gains benefits as well as maximum flexibility in drafting the transfer agreement may be obtained.

A. Section 1235

Among the advantages of section 1235 is, first, that the inventor may disregard the problem of being characterized as a professional.⁹⁷ Second, since there is no holding period requirement, the inventor need not worry about when a reduction to practice operates to commence the running of a holding period, an especially troublesome obstacle where there is a requirement that improvement patents be

⁹¹ *United States v. Carruthers*, 219 F.2d 21 (9th Cir. 1955); *Kavanaugh v. Evans*, 188 F.2d 234 (6th Cir. 1951); *Vincent A. Marco*, 25 T.C. 544 (1955).

⁹² *First Nat'l Bank v. United States*, 136 F. Supp. 818, 824 (D.N.J. 1955); *Ernest E. Rollman*, 25 T.C. 481 (1955).

⁹³ See, e.g., *Merck & Co. v. Smith*, 261 F.2d 162 (3d Cir. 1958); *United States v. Carruthers*, 219 F.2d 21 (9th Cir. 1955).

⁹⁴ E.g., *Moberg v. Commissioner*, 310 F.2d 782 (9th Cir. 1962); *Gowdey v. Commissioner*, 307 F.2d 816 (4th Cir. 1962).

⁹⁵ *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. 1955).

⁹⁶ *Merck & Co. v. Smith*, 261 F.2d 162 (3d Cir. 1958).

⁹⁷ Reg. § 1.1235-2(d)(3) (1957), as amended, T.D. 6394, 1959-2 CUM. BULL. 186.

automatically transferred. Third, there is assurance that royalty payments will not be treated as ordinary income, whereas a vestige of this problem may yet remain under sections 1221 and 1231.⁹⁸

The principal disadvantage of section 1235 is that only a limited category of transferors will qualify. Corporations and persons who are not otherwise "holders" are expressly excluded.⁹⁹ Also, if the transferee is a controlled corporation, the transfer will not qualify.¹⁰⁰ Lastly, the "substantial rights" requirement is highly restrictive in that it does not permit a transfer which is limited geographically,¹⁰¹ but there is recent dictum to the contrary.¹⁰² A number of these disadvantages are nonexistent under sections 1221 and 1231.

B. Sections 1221 and 1231

A distinct advantage of sections 1221 and 1231 is that virtually any transferor may obtain capital gains treatment subject to certain limitations.¹⁰³ The permissible categories of transferees are greatly expanded. For example, one may transfer section 1231 property to a corporation of which up to eighty per cent of the outstanding stock is owned by the transferor.¹⁰⁴ Moreover, the sale or exchange of section 1221 property may qualify for capital gains treatment regardless of the extent of the transferor's ownership interest in the transferee. Equally important is the fact that transfers which are limited geographically may receive beneficial treatment.¹⁰⁵

⁹⁸ See Kurtz, *Distinctions Between License and Capital Transaction on Transfer of Patent*, N.Y.U. 23D INSTR. ON FED. TAX 135 (1965) in which Mr. Kurtz is of the opinion that *Commissioner v. Brown*, 325 F.2d 313 (9th Cir. 1963), *aff'd*, 380 U.S. 563 (1965), may have some effect on the patent area. There the government lost a non-patent case in which it took the position that periodic payments should not be accorded capital gains treatment.

⁹⁹ This is so, since the primary purpose of § 1235 was to aid the individual inventor.

¹⁰⁰ For the purposes of § 1235 the transferor may not own more than 25% in value of the outstanding stock of the corporation.

¹⁰¹ Reg. § 1.1235-2(b) (1) (1957), as amended, T.D. 6852, 1965 INT. REV. BULL. NO. 44, at 9.

¹⁰² In *William S. Rouverol*, 42 T.C. 186, 141 U.S.P.Q. 419 (1964), *nonacq.*, 1965 INT. REV. BULL. NO. 45, at 5, the Tax Court quoted from *Merck & Co. v. Smith*, 261 F.2d 162 (3d Cir. 1958), to the effect that one owning a single invention patent may "sell" its use in a particular territory.

¹⁰³ The primary limitation is being characterized as a professional inventor.

¹⁰⁴ CODB § 1239.

¹⁰⁵ *Moberg v. Commissioner*, 310 F.2d 782 (9th Cir. 1962); *Estate of Gowdey v. Commissioner*, 307 F.2d 816 (4th Cir. 1962); *Dairy Queen, Inc. v. Commissioner*, 250 F.2d 503 (10th Cir. 1957); *Thornton G. Graham*, 26 T.C. 730 (1956). See also *Schmitt v. Commissioner*, 271 F.2d 301, 304 (9th Cir. 1959); *Watson v. United States*, 222 F.2d 689, 690 (10th Cir. 1955).

The two most formidable barriers to beneficial treatment are the holding period and the characterization of the inventor as a professional. These barriers are frequently the reason for seeking benefits under section 1235. However, because of the limited nature of section 1235, capital gains benefits may be unavailable, and the taxpayer will be compelled to report his gain from the transfer of patent rights as ordinary income.

V. CONCLUSION

From the foregoing one may ascertain that there is a disparity between the tax treatment available under section 1235 and that available under sections 1221 and 1231. It is quite evident that the extension of capital gains treatment is much more liberal under the latter sections. But since the purpose of section 1235 was to promote inventive activity, this disparity appears to be unjustified.¹⁰⁶

In view of this situation, it is submitted that section 1235 be amended to afford the benefits obtainable under sections 1221 and 1231. This may be implemented by the adoption of rules analogous to the elements of a transfer announced in *Waterman*.¹⁰⁷ In so doing, the purposes of section 1235 and the business needs of the individual inventor will be more fully realized.

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¹⁰⁶ There is also the often quoted phrase: "Certainly the courts have been quick to heed Congress' invitation to construe liberally sections 117(q) and 1235." *Young v. Commissioner*, 269 F.2d 89, 93 (2d Cir. 1959).

¹⁰⁷ 138 U.S. 252, 255 (1891). For a discussion of this case, see text accompanying notes 89, 90 *supra*.