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A client presents the following set of facts relating to the sale of patent rights and requests you, as his attorney, to advise him as to the legal problems that might arise in a transfer of the invention.

A and B are the partners of a firm which has held certain inventions for several years. They are also stockholders of corporation C each holding forty (40) per cent of the capital stock; the remaining twenty (20) per cent is owned by outsiders. A and B consult you regarding the possibility of having corporation C acquire by purchase from the partnership one of the inventions owned by the latter. The partnership holds many patent rights but so far has never sold any. The partners have been allowed depreciation on these interests under Section 1231 of the Revenue Code. The questions as to how the price is to be fixed is presented, whether the minimum purchase price, honestly estimated from past commercial royalties, plus or minus actual receipts, possibly including awards for past and future infringements, are to be considered. Should "unrealized receivables" be taken into account under Section 751 and finally, should the partnership be liquidated before a sale is made to the corporation?

The first point requiring consideration is the nature of the interest held by the inventor in his invention. Section 1235 of the Internal Revenue Code of 1954 undertakes to settle this question, which gave rise to much confusion in the earlier cases. Before the adoption of the 1954 Code, inventors who made a business of inventing and selling their patented products were classed as professional inventors, and the amounts received were treated as ordinary income. If on the other hand a person was not in the business of producing inventions and selling them

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to customers but produced and patented an article which might or might not be incidental to his regular occupation, he was classed as an amateur and was given capital gain treatment if he sold his patent.

Section 1235 of the 1954 Code did away with the distinction between professional and amateur inventors. It defined an inventor as the creator of the invention, meaning the "first and original" inventor. The transfer of a patent or patent interest by a holder is considered the sale or exchange of a capital asset held for more than six months, regardless of whether payment is to be made periodically over a period of time or contingent on "the use or disposition of the property." A holder is defined by this section as an individual whose efforts have produced the property or a person who has acquired the same for a "consideration in money or money's worth." Related persons, except brothers or sisters, are not deemed holders under this section. A corporation does not qualify as a holder, even though the corporation is the equitable owner of the patent.[1]

Thus we see that if the patents are held for investment, the gain or loss is a capital gain or loss. If the taxpayer, other than a holder as defined in section 1235(b)(1) and (2), is engaged in selling patents to customers, any gain or loss therefrom is given ordinary income treatment.[2] Since a partnership cannot be a holder under the patent law, each member of a partnership who is an individual qualifies as a holder, and holds a share of any patent owned by the partnership.[3]

It is pointed out by a writer on this subject that Section 1235 does not claim to cover all possible situations and that as a consequence resort must be had to decisions under the prior law.[4] Another authority on this field of law states this fact in the following words:

> The tax consequences of the sale of patents in years to which this section [Section 1235] is inapplicable, or by individuals who fail to qualify as 'holders,' or by corporations, will be governed by the law in effect prior to the enactment of the 1954 Code.[5]

[1] Int. Rev. Code of 1954, § 1235(d).
[2] P-H 1959 Fed. Tax Serv., Vol. 1, par. 5401, Sec. 1231(b).
[3] Id. par. 5404(d)(2).
[4] Frost, "Tax Consequences of Patent Transfers," 7 Stan. L. Rev. 349 (1955).
[5] Joseph, "Tax Treatment of Sales and Licenses of Patents," 32 Taxes 803 (1954).

Our attention is also called to the fact that there are comparatively few Supreme Court decisions dealing with patent law. It was not until the Act of 1948 was passed that a general jurisdiction to review decisions of the Court of Customs and Patent Appeals was given. The Supreme Court has seemed very reluctant to grant writs of certiorari in such cases. This reluctance, it is suggested, may be due to the fact that the Court may believe that the lower courts possess the expert knowledge necessary to deal with the matter.[6]

Many of the cases reviewed by the Supreme Court dealing with points not expressly covered by Section 1235 have been to determine whether the transfer in a particular case was an assignment of a patent or the granting of a license. In *Waterman v. Mackenzie*[7] it was held that the words in a transfer that "the sole and exclusive right and license to manufacture and sell" the patented article throughout the United States were not an assignment but a license, and that the assignee was not entitled to prosecute for infringement. It has been pointed out that it is the character of the agreement, not the terms used, such as "licensor" or "licensee," that is looked to in determining whether a transfer is a sale or the creation of a license. The Tax Court, in deciding the often cited case of *Meyers v. Commissioner*,[8] held that an exclusive license amounted to a sale of the patent in question. Annual payments were provided for, designated as "royalties." "An exclusive license" was granted to "use, manufacture and sell the invention."

The question of whether the partnership in such case should be entitled to the invention or the employee, becomes of interest. A circuit court, in referring to an agreement between an employer and an employee that such patents should belong to the employer, said in *Magnetic Mfg. Co. v. Dings Magnetic Separator Co.*[9] that the contract of employment need not be in writing and that no formal words are necessary. Where part of the employee's time is to be used to develop new or improved devices, the

[6] Gilbert, "The Constitutionality of Supreme Court Review of Patent and Trademark Decisions of the Court of Customs and Patent Appeals," 45 Geo. L. J. 645 (1954).

[7] 138 U. S. 252 (1891).

[8] 6 T. C. 258 (1946).

[9] 16 F. 2d 739 (7th Cir. 1926). See also Dinwiddie v. St. Louis & O'Fallon Coal Co., 64 F. 2d 303 (4th Cir. 1933).

patents covering these improvements belonged to the employer. Where, however, an invention has been made by an employee outside of his employment, it is held the patent belongs to him.[10] Where an invention has been made by a government employee while discharging duties assigned to him, it has been ruled that the invention became the property of the United States.[11]

In a very recent decision the defendant was hired at a fixed salary. There was no specific agreement as to ownership of patents developed by the employee. The Third Circuit Court held the employer would be entitled to an assignment of any patent taken out by an employee by showing: (1) an express agreement to that effect, or (2) that the employee was hired to invent and patent devices affecting the subject of the employment agreement. In the particular case there was no agreement to assign or for the employee to invent.[12] The Court followed the line of reasoning laid down in *Hapgood v. Hewitt*.[13]

One of the very first questions for the attorney to consider in solving the problem presented is whether the transfer of the patented invention should first be transferred to the corporation and then to the client or whether the partnership should first be dissolved and the patent transferred to the partners as individuals and let them make the transfer to the corporation or directly to the buyer. Consideration, of course, should be given the effect the elimination of the partnership or the corporation, or both, by dissolution, would have on the income taxes of the partners or their right to possible deductions. There would be no income created by the transfer to the partners, individually or otherwise, if the partnership were to be dissolved and its assets divided among them according to their shares in the partnership. In a recent case the appellate court ruled that in liquidation proceedings the proceeds from the sale of pipe that came into the hand of the liquidating agents as capital assets were subject to capital gains tax and not ordinary income tax.[14] This shows that in dissolving the partnership, the question of whether a capital gains tax would be payable should be taken into consideration.

[10] Dowse v. Federal Rubber Co., 254 Fed. 308 (D.C.N.D. Ill., 1918).
[11] Houghton v. United States, 23 F. 2d 386 (4th Cir. 1928).
[12] DeJur-Amsco Corp. v. Fogle, 233 F. 2d 141 (3d Cir. 1956).
[13] 119 U. S. 226 (1886).
[14] Greenspon v. Commissioner, 229 F. 2d 947 (8th Cir. 1956).

It is also difficult to see how a transfer by the partners as individuals to the corporation in which they own the controlling interest would be of advantage. In the Tax Court decision of *Leo P. Curtin*,[15] the taxpayer transferred the title of his invention to a personally controlled corporation in exchange for the right to receive royalties for seventeen years. It was held that the transaction was not an assignment of his interest in the patent that would relieve him from paying income taxes on income coming to him as assignee. The court said that it is well established that such an arrangement did not have "the effect of shifting tax liability on such income and profits."

The United States Supreme Court in 1938 passed upon the taxability of a shareholder's gain upon liquidation of a corporation. A Treasury Regulation at the time stated that any gain coming to a stockholder from a distribution in liquidation should be taxed as a capital net gain in conformity with Section 101 of the Revenue Act of 1928 and Section 115 (c), which are to be read together. Gains or losses on liquidation of the corporation, the court ruled, "are taxed on the same basis as gains or losses upon sales and exchanges of property, with the rate prescribed by Section 101."[16]

The questions as to the effect of the methods of payment and conditions incorporated in the agreement transferring interests in patents frequently come before the court. The fact that payment is to be made in periodic installments has the approval of the judges. In *Commissioner v. Hopkinson*,[17] making of lump sum payments did not prevent the transaction from constituting a sale of capital assets. The payments received after the transferor's base had been extinguished were taxed as capital gains. The sum payable for transferor's interest was dependent upon a percentage of the royalties received by the buyer. In *Kronner v. United States*[18] the patentee gave the "sole right to manufacture, vend, sell, license or relicense or in any wise use device covered by patent when issued." It was held a "sale" within Section 117(a)(1) [I.R.C. 1939] although a clause in the agreement allowed either party to cancel the agreement

[15] 16 P-H Tax Ct. Mem. Dec. par. 47115, at 394 (1947).
[16] White v. United States, 305 U. S. 281, (1938).
[17] 126 F. 2d 406. (2d Cir. 1942).
[18] 110 F. Supp. 730, 126 Ct. Cl. 156 (1953).

upon the giving of notice provided for in the agreement. A very recent case where payments were to be made in installments is *Rollman v. Commissioner.*[19] Installment payments, the court ruled, did not prevent the transaction from being a sale of capital asset.

The 1954 Act incorporates this view in Section 1235(a)(1). There it is provided that the sale of a patent right or interest therein shall constitute a sale or exchange of a capital asset held for more than six months, regardless of the fact that the amount due the tranferor is (1) "payable periodically over a period generally coterminous with the transferee's use of the patent, or (2) contingent on the productivity, use or disposition of the property transferred."

It is not to be overlooked that Section 751 of the Internal Revenue Code states that a partner in transferring his interest in a partnership, in arriving at the market value of his interest in the partnership property, is to take into consideration the "(1) unrealized receivables of the partnership," (the amount due for goods sold on credit, for instance), "or (2) inventory items of the partnership which have appreciated in value." These provisions relate to the sale of property other than capital assets or to services rendered by the partnership.

Since the monopoly granted a patentee expires at the end of seventeen years, patents are exhaustible assets and come within the provisions of the income tax law allowing depreciation on the value of the patent.[20] In arriving at the basis, the costs of developing and promoting the patent are "capital expenditures" properly amortizable over the period the patent runs, the seventeen years, in making deductions from the income from the patent right.[21] It is fair to assume that the patent holders in the case presented have been allowed depreciation on any income received from their patent rights, in conformity with the provisions of Section 1231 of the Code on property used in trade or business and on property held for producing income, as stated in Section 167.

Any damages the holders of the patent may have recovered for infringements of their invention while they held the same

19 244 F. 2d 634. (4th Cir. 1957).
20 Int. Rev. Code of 1954, § 12.
21 Massey v. United States, 226 F. 2d 724 (7th Cir., 1955).

would be subject to income taxes.[22] However, where the contract sale of a patent provided that any amounts recovered in pending suits for infringements should belong to the assignor, who was the inventor, the Tax Court has recently held the receipts from the pending suits should be held to be a part of the sales price and taxable to him as a capital gain.[23]

The Court of Appeals for the Eighth Circuit, acting under prior law, pointed out that expenditures made in research and developing inventions are "capital expenditures" and not deductible as "ordinary and necessary business expenses." The patent development expenses must be capitalized and charged to expense account.[24] The same conclusion was reached by the Board of Tax Appeals in the earlier case of *Claude Neon Lights, Inc. v. Commissioner*.[25] Section 174 of the U. S. Code deals with expenditures incurred in experimentation in connection with one's trade or business which are not chargeable to capital account (that is, capitalize the research expense), but excludes property subject to allowance under Section 167 or Section 611. The former section relates to allowance of depreciation and the latter to allowance for depletion.

Provisions are made in Sections 1301-1304 for prorating compensation from employment by an individual or a partnership or derived from an invention or artistic work, or received from back pay, over a period of time. It is stipulated that in the case of employment the tax so prorated "shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt or accrual."

In the case of employment the period covered is thirty-six months or more from the beginning to the completion of such employment. In the case of inventions or artistic work the period covered is twenty-four months or more from the beginning to the completion of the work. The tax in such case is not to exceed "the aggregate of taxes attributable to such part had

[22] Rosenzweig v. Commissioner, 1 T. C. 24 (1942).
[23] Graham v. Commissioner, 26 T. C. (1956).
[24] Hart-Bartlett-Sturtevant Grain Co. v. Commissioner, 182 F. 2d 153 (8th Cir. 1950).
[25] 35 B. T. A. 424 (1937).

it been received ratably over, in the case of inventions, 60 months, or the part of the year preceding the close of the taxable year, whichever is shorter."

Where the taxpayer showed he had conceived the idea and thought about his invention thirty-six months prior to its completion but had not begun actual work on the same, it was held he failed to qualify for the benefits of the section covering inventions.[26]

The problem of fixing the basis of transferred property has given rise to a great deal of litigation. The establishing of a basis comes up most often in determining the tax arising out of the transaction. This may be for computing the income tax to be paid or it may be for determining the amount to be allowed for yearly depreciation in computing the capital gain or loss if the purchaser sells the property he has acquired. In any case, it will generally be the fair market value of the property at the time it is acquired that will be approximated. In a fairly early case it was held that in reporting income from the taxpayer's sale of sugar the taxpayer might deduct from his gross returns his cost and expenses, attributable to the production of such income.[27]

The court is not, however, in such case obliged to accept the taxpayer's figures as to the cost of any improvements made.[28] It can be added that in the fair market value of property acquired by descent, for instance, the figures reached at such time are only prima facie correct and may be shown to be erroneous.[29] If stock is taken in payment for a debt of a solvent debtor, the amount of the cancelled debt is taken as the basis.[30] In *Parsons v. United States*,[31] it was said the basis of property should be the cost to the taxpayer as represented by his outlay, "measure of his recoupment through depreciation accruals."

In case of a partner computing his net gains or losses from the sale of property used in his trade or business, he is required by law to include his share of partnership gains or losses

[26] Beardsley v. U. S., 140 F. Supp. 541 (D. Conn. 1956).
[27] United States v. Amalgamated Sugar Co., 12 F. 2d 755 (10th Cir. 1934).
[28] Lipsitz v. Commissioner, 200 F. 2d 871 (4th Cir. 1955).
[29] McEwan v. Commissioner, 241 F. 2d 887 (2d Cir. 1957).
[30] Owen v. Commissioner, 134 F. Supp. 31 (D. Neb. 1955), *appeal dismissed*, 232 F. 2d 893.
[31] 227 F. 2d 437 (3d Cir. 1955).

as stated in Section 1001 of the Code.[32] As pointed out in a decision of a year ago,[33] in adjusting gains or losses from sales of property, wherever acquired, the provision as to time elements "broadens" to include property transmitted by death.[34] The fact that property enhances in value does not give the owner a taxable gain.[35]

The "first in first out" rule was applied by the Tax Court in *Kaleck v. Commissioner*,[36] where a corporation did not indicate whether payments to stockholders were long term or short term in returning advances made by the stockholders upon the dissolution because of failure of business. The sums returned were applied to the earliest advances made by the stockholders. In the case of *Hamilton v. Commissioner*,[37] a building was purchased under an agreement whereby it was stipulated the tenant should restore the building to its former condition to the extent of $10,000. The purchaser released the tenant from this obligation. This amount, $10,000, was deducted in computing the purchaser's cost basis. In another case before the Tax Court, a taxpayer purchased two public utility corporations, including all the outstanding stock of one and the outstanding securities of the other. The purchaser liquidated the newly acquired subsidiaries and assumed their liabilities. It was held that the basis of the taxpayer's purchases was the price of the stock and securities plus the amount of the liabilities.[38]

A taxpayer petitioning the Tax Court for a redetermination of income and excess profits taxes assessed in 1944, 1945 and 1946 increased cost basis of depreciable items of another corporation the taxpayer purchased in 1929. It erred in failing to deduct allowable depreciation on cost accession or increment from 1929 to 1944 as well as depreciation thereafter actually allowed for such period.[39]

The cases already considered, which have fixed the cost basis of property acquired as the fair market value at the time

[32] Commissioner v. Paley, 232 F. 2d 915 (9th Cir. 1956); *cert. denied*, 352 U. S. 838 (1956).
[33] Supra note 29.
[34] Commissioner v. Murphy's Estates, 229 F. 2d 569 (6th Cir. 1956).
[35] Commissioner v. Summer's Estates, 231 F. 2d 909 (4th Cir. 1956).
[36] 23 T. C. 672 (1955).
[37] 25 T. C. 878 (1956).
[38] Montana-Dakota Utilities Co. v. Commissioner, 25 T. C. 408 (1955).
[39] Commissioner v. Superior Yarn Mills, 228 F. 2d 736 (4th Cir. 1955).

of the purchase, have the support of a recent holding in the United States Supreme Court. One case, where certiorari was denied by the Supreme Court, the taxpayer, who owned a half-interest in a corporation, purchased the other half in the corporation and dissolved the corporation. He had half the assets transferred to himself and his wife. The property thus acquired took its cost basis for income tax purposes as the fair market value at the time of the dissolution of the corporation.[40] This is in keeping with Section 334 of the Code, which gives the general rule that if property is received in a distribution in partial or complete liquidation and a gain or loss is recognized on the receipt of the property, the basis of the property in the hands of the distributee shall be the fair market value of the property when distributed.[41] Exceptions pointed out in the Code are (1) property distributed pursuant to a plan adopted on or after June 22, 1954, and (2) where more than two years after the date of transaction have elapsed.

The basis for assets purchased is, as a general rule, held to be the cost,[42] but in the case of *Georgia Properties Co. v. Henslee*[43] a different result was reached. The corporation owning an office building refused to sell the building. One desiring to purchase the building purchased all the outstanding shares of the corporation and liquidated the company. It transferred the shares bought in exchange to the corporation in liquidation. The amount the taxpayer paid for the stock was held to be the basis for computing the depreciation on the building acquired in the liquidation proceeding. The taxpayer was not required to use the adjusted basis of the assets of the corporation in computing depreciation.

The Code goes into detail in the matter of finding the basis for property acquired by transfer and many sections are devoted to the subject of determining the gains or losses the transferee is required to consider in his computations, whether the property be acquired by purchase, descent or gift. It also considers what costs and expenditures he can add to the price paid. As shown by the court decisions already considered, the basis to

[40] Lipsitz v. Commissioner, 220 F. 2d 871 (4th Cir. 1955), *Cert. denied,* 350 U. S. 845 (1955).
[41] 26 U. S. C. A., § 334 (a) (1954).
[42] Brown v. Commissioner, 24 T. C. 27 (1956).
[43] 138 F. Supp. 587 (M.D. Tenn. 1955).

be taken, as a general rule, is the fair market value at the time the acquisition takes place. In the case of the dissolution of a corporation, it is laid down that the "basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made."[44]

In the case of a partnership other than in a liquidation of the partnership, the partner's interest in the firm is reduced by the amount he takes out, but not below zero. An optional basis is allowed by the Code.[45] Where the property comes to the holder by descent[46] or gift[47] the method of determining the basis is stated to be the fair market value of the property in the former case at the date of the decedent's death and in the latter case the basis of the property in the hands of the donor. In the case of the descent of the property an alternative method is provided for at the election of the transferee.[48]

Applying those principles and rules so far considered to the facts presented in the hypothetical case stated at the outset, it seems clear that the gain or loss from the partnership sale of the patent right it has held for some time results in a capital gain or loss. The result would be otherwise for other than a holder as defined in section 1235(b)(1) and (2) if it had been in the practice of selling such inventions to customers; the gain or loss in such case would be an ordinary gain or loss and taxable as such. The same result would have been reached under the law in force before the adoption of the 1954 Code.

The basis of valuation would be the original cost provided it was the fair market value, less the depreciation allowed during the time the patent was held. Depreciation on patent rights is worked out on the basis of seventeen years, since a patent right runs for that period. Any expense or outlay on the property right held will also be deducted, and any income from the patent or any sum recovered in suits for infringement of the patent would be added to amount received. While the partnership as such may hold the title to the patent, the partners,

[44] 26 U. S. C. A., § 334 (b) (2) (B) (1955).
[45] Int. Rev. Code of 1954, §§ 733, 751-55.
[46] Int. Rev. Code of 1954, § 1014.
[47] Int. Rev. Code of 1954, § 1015.
[48] Election allowed under Section 2032 of the 1954 Code or Section 811(j) of the Int. Rev. Code of 1939 results in such elected value forming the basis of the property in the hands of the recipient. Int. Rev. Code of 1954, § 1014.

if they qualify as holders under the terms of the statute, are deemed the holders of the patent right. From this fact it would seem that the liquidation of the partnership would be largely a matter of bookkeeping.

Turning to the case presented: the corporation was regularly engaged in business and was not a "dummy" created for the purpose of making the sale or transfer of the patent. Furthermore, the holders of the 20% of the corporate stock were not related persons to whom the statute forbids conveyance. If the holder of the patent right owned more than a 50% interest in the corporation it might be treated as a transfer to a related person, and as a result, under section 1235, the holder would not be entitled to capital gain treatment. It has been pointed out that an invention would not be a capital asset in such a case.[49] What was to be regarded as a capital asset was considered in Section 117 (a)(1), I.R.C. (A) as amended in 1941. It did not include property held primarily for sale to customers, nor property used in trade or business which was subject to allowance for depreciation under Section 23 (1). The court, in *Lamar v. Granger*,[50] says, "However, in general so far as patents are concerned, if the income-producing activity in connection with a patent is an isolated or casual affair or a mere hobby or recreation, the patent is a capital asset."

Since the particular invention in question had been held by the partnership for several years and had not been offered for sale to the firm's customers, a court should hold that it was a capital asset and subject to capital gain treatments. It is difficult to find under the circumstances how there would be any advantage gained by transferring the patent right to the corporation and allowing it to pass it on to a would-be buyer.

Finally, in arriving at a basis for valuation of the patent right, any awards for infringements of the patent should, of course, be taken into consideration. As we have seen, if the damages from infringement are recovered before the patent has been sold, the proceeds are taxed as ordinary income. If recovered after the sale, the damages are treated as though a part of the sale price.

[49] Andrew W. Bailey, 15 N.Y.U. Institute of Federal Taxation 285, 310 (1957).

[50] 99 F. Supp. 17, 41 (W.D. Pa. 1951).