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The Income Tax of the Inventor

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EDITORIAL NOTES

THE INCOME TAX OF THE INVENTOR.—The struggling inventor raised to sudden opulence when his invention is perfected and recognized is probably more common in story books than in real life. Nevertheless many important discoveries which now bless our civilization have come to light under such circumstances and will probably continue to do so, notwithstanding the advantages afforded by the experimental laboratories of large corporations. An important object of the laws relating to inventions and patents has been to encourage individual initiative. The purpose of this note is to suggest changes in our income tax laws that will bring them into harmony with this general policy.

Under the law as it now stands the expenses of developing an invention and obtaining a patent are used as a basis for a depreciation allowance[1] or may be deducted from the selling price in determining profits from a sale,[2] for income tax purposes. This amount, if the invention is of consequence, will be quite insignificant in comparison with the amount realized from the sale or use of the patented device or process. Although the inventor may have devoted years of unremunerated labor to developing and per-

[1] Regulations 74, Art. 207; Appeal of Gilliam Mfg. Co., 1 B. T. A. 967 (1925).

[2] Buffalo Forge Co. *v.* Commissioner, 5 B. T. A. 947 (1926).

fecting his invention he must pay income taxes, including surtaxes, on the sums received at the time he is able to reap the fruits of his toil.

It is true that in most instances his income will be in the form of royalties extending over a period of years. If he sells his patent for a specific sum, he may be able to arrange to receive it in yearly installments thus cutting down surtaxes. Moreover, under the present law which gives the taxpayer the option of paying a 12½ per cent tax on capital gains from property held more than two years,[3] the hardship on the inventor who sells his patent is not so great as it was in former years. Nevertheless, taking all this into account, the inventor is not apt to be so well situated from the point of view of income tax payments as the person who is paid for his services as he renders them. And this is aside from the consideration that in order to encourage invention, the income tax law might well place the inventor in a situation more favorable than that of other taxpayers.

In the case of mineral lands, Congress has seen fit to encourage prospecting by providing that depletion allowances for property on which minerals are discovered are to be determined on the basis of a "discovery" value.[4] This means that the fair market value of the property at the date of discovery, or within thirty days thereafter, if this is materially disproportionate to the cost, may be used in computing the depletion allowance, provided such allowance does not exceed 50 per cent of the taxpayer's net income.[5] Also, in the case of a sale, although the profit is not determined on the basis of the "discovery values",[6] yet the surtaxes on the profits of such sale are limited in all cases to 16 per cent of the selling price of the property.[7]

The analogy between the discovery of minerals and an invention is not difficult to see. In the case of both there is a public interest in encouraging effort and outlay of money in a search that may prove unavailing. In the case of both there may be a period of unrewarded labor followed by a sudden realization of

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3 This provision was first enacted in 1921, and applies to sales after December 31, 1921. Revenue Act of 1921, §206 (b), 42 Stat. 233. Revenue Act of 1928, §101.

4 Revenue Act of 1928, §114 (b).

5 The allowance for depletion in each year is so computed that the aggregate of annual deductions during the period of productivity will be equal to the basis of depletion, in this case, the discovery value. The practical result is to exempt the owner of the land from liability for income tax on the increase in value of the land resulting from the discovery.

6 Appeal of Hunt, 4 B. T. A. 1077 (1926).

7 Revenue Act of 1928, §102 (a).

large profits within a short time.[8] There appears to be no reason for giving special privileges to the owner of mineral lands that are not given to an inventor. The explanation is doubtless to be found in the fact that oil companies have lobbied extensively in the interests of the discoverers of mineral deposits.[9] It is believed that Congress might give to an inventor similar privileges, if the matter were brought to its attention.

It is not clear why Congress saw fit to allow discovery value as a basis for determining depletion deductions for mineral land and not for calculating sale profits. In practically all other cases the capital asset is treated as having the same value for both purposes. The 16 per cent limitation on surtaxes is now of less significance than formerly in view of the option given to pay a 12½ per cent tax on capital gains from property held more than two years.[10] If, in the case of patents, Congress should see fit to allow a discovery value for depreciation deductions and not for sales profits, it would simply mean that an inventor, to take advantage of the law, would have to retain title to his patent, and receive his royalties under a licensing agreement.[11] It would seem preferable that the law should value the capital asset in the same way for both purposes.

Once the general principle that the inventor is entitled to legislative relief is recognized, there arises a very difficult technical problem as to how discovery value is to be determined. Three dates as of which the valuation might be made suggest themselves, (1) the date of the invention as that term is used in interference cases, (2) the date of the application for a patent, (3) the date of the patent.

The first date is open to several objections. If that date itself is taken it would, in the majority of cases, afford no relief whatever to the inventor. If the conception of the inventor is diligently reduced to practice within a reasonable time or the patent is applied for soon after the conception, the inventor is entitled

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[8] *Cf.* Fowler *v.* United States, 11 F. (2d) 895, 896 (1926), affirmed 16 F. (2d) 925 (1927), referring to the discoverer of mineral lands. "He has searched for years fruitlessly, and it hardly seems fair that one year's triumph should carry such a large burden, when many years of failure have sharpened his experience and probably resulted in his successful search."

[9] See Fowler *v.* United States, *supra*, p. 896.

[10] *Supra*, n. 3.

[11] The Committee on Repeals and Reviews ruled in one case that, although a patent had been assigned under an agreement whereby the assignor was to have 40 per cent of the profits, the assignor was entitled to a depreciation allowance. Comm. Mem. 35, 2 C. B. 142. This is only to be explained on the theory that the assignor retained a 40 per cent equitable property interest in the patent.

to take the date of the conception as the date of the invention.[12] In such a case it is obvious that a valuation on the date of the invention would be of no advantage. If it should be provided that the valuation was to be made within three years from the date of the invention that objection would be obviated, but the determination of that date is attended with extraordinary difficulty, as any interference case readily reveals.[13]

If the date of the application for the patent is taken as the valuation date, the advantage of certainty in the date is attained. Usually the invention will have attained some ascertainable value by that time, although in many instances it will be very small compared to the ultimate value if the discovery is of any importance. There is, however, the objection that an inventor, who will nearly always be advised by attorneys, may be induced to defer his application in the hope of saving on income taxes. This would of course not be desirable.

The date of the patent would not seem satisfactory because of the great discrepancy between the periods between the dates of application and issuance in the case of different patents. If the patent proceedings are held up, it may be a number of years before letters patent issue and by that time all the doubts which serve to keep down the value of the invention may be resolved. If the patent date is taken as the valuation date in such cases, the inventor might have to pay no income taxes at all.

On the whole the best solution would seem to be to permit the valuation to be made within six months from the date of application, provided the patent is applied for not more than three years after the date of invention. This would prevent undue delay by the inventor in making application for his patent, would in most cases give the inventor substantial relief, and would raise the uncertain question of the date of the invention in only a few cases.

Other methods of determining the discovery value could of course be suggested, but it is doubtful if any can be devised that will take into account all the different circumstances under which inventions and patents come into existence. Some inventions achieve recognition quickly, while others of paramount significance do not come into their own for many years. This difference would be taken care of to some extent in the actual determination of value. Where inventions achieve value quickly, the policy of valuation might well be more strict than where the ultimate importance of the discovery is not realized for a number of years.

[12] See Automatic Weighing Machine Co. *v.* Pneumatic Scale Corp., 166 Fed. 288 (1909).

[13] *Ibid.*

It seems impossible to work out a permanent satisfactory scheme for taxing inventors' incomes without further action by Congress. In the meantime, since much litigation as to income derived from patents involves inventions prior to March 1, 1913, considerable relief might be afforded to the inventor by a liberal policy of valuation of patents, patent applications and inventions on the basic date. The Board of Tax Appeals has held in a number of cases that the mere fact that an inventor had not yet obtained his patent by March 1, 1913, would not prevent him from computing depreciation or sales profit on the basis of the valuation of his patent application on that date.[14] It would seem a proper extension of this principle to allow such valuation where an application for a patent had not been made but the invention had been perfected before that date.[15] It is, of course, difficult to obtain evidence as to the value of an invention before the device or process has been tested out. The regulations provide that evidence of the 1913 value must be "affirmative and satisfactory."[16] The spirit of this regulation, however, has not been strictly followed by the Board of Tax Appeals. It has admitted the retrospective opinions of experts and has allowed such opinions to be supported by evidence of earnings resulting from the use of the patent subsequent to the basic date.[17] In a few cases it has declined to fix a value, the evidence presented being deemed insufficient.[18]

Even a liberal policy of valuation, however, can prevent hardship in only a relatively few cases. A change in the income tax law is necessary if inventors are properly to be encouraged and the hardship upon them is to be obviated.

—HAROLD C. HAVIGHURST.

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[14] Individual Towel & Cabinet Service Co. *v.* Commissioner, 5 B. T. A. 158 (1926); Hartford-Fairmont Co. *v.* Commissioner, 12 B. T. A. 98 (1928); Appeal of Commercial Truck Co., 5 B. T. A. 602 (1926). See also Saunders *v.* Commissioner, 29 F. (2d) 834 (1929).

[15] The reasoning in the Saunders Case, *supra*, proceeds upon the theory that an unpatented invention is property and apparently nothing turned upon the fact that the application had been filed.

[16] Regulations 72, Art. 207.

[17] See Frederick Leon Pearce, "Evidence of the Value of Patents", 6 N. I. I. M. 167.

[18] Union Paper Co. *v.* Commissioner, 9 B. T. A. 1010 (1927); Appeal of Commercial Truck Co., *supra*, n. 14.