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TAXATION PROBLEMS RELATING TO PATENTS AND OTHER INTANGIBLE INDUSTRIAL PROPERTY

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On the Patent Office building in Washington appears the inscription "The Patent System Added the Fuel of Interest to the Fire of Genius." This famous quotation by Abraham Lincoln has now been modified by a damper to the fire in the form of the Internal Revenue Code. Ever since 1913, the difficulties presented to inventors and patent holders, as well as other taxpayers, have been increasing. I shall not attempt in this paper to explore all the ramifications present in this damper, but shall try to point out some of the major problems confronting the individual fortunate enough to be granted a patent by our Government.

When a patent is finally issued by the Patent Office, the holder of this official document is mainly concerned with attempting to augment his depleted coffers by the sale, assignment or license of the rights granted by the patent. It is very important at this stage of the game to determine the classification of the inventor. Is he a professional inventor who uses his inventive capacity to provide a livelihood? Or is he an individual who has merely been struck by the so-called "flash of genius" and has perfected his once-in-a-lifetime invention? We can go somewhat further and possibly allow this latter individual to secure several occasional patents, but he must not be permitted to lose his amateur standing.

This first possibility existing for the inventor is the outright sale of all rights granted by the patent. Although it is difficult to determine the future value of a patent as long as the possibility exists that it may sometime be brought to the attention of the Supreme Court, nevertheless, we will assume that a value has been established, and a willing buyer has been contacted and subdued.

For our amateur inventor, no great problem exists in the sale of his rights. He is mainly interested in establishing the transaction as a long-term capital gain under Section 117 of the Internal Revenue Code, and to this end, assistance has been granted by the courts. If the necessary holding period of 6 months has been complied with, the courts have permitted the amateur inventor to qualify the transaction as a long-term capital gain.[1] In determining the period of 6 months, a starting date for the holding period is permitted as being the time of reduction to practice of the invention,[2] and not as of the date of issuance of the patent.

[1] Maurice Bacon Cooke et ux, 4 TCM 204; James H. Adamson, 5 TCM 1071; Edward C. Myers, 6 TC 258; William M. Kelly, 6 TCM 646; John W. Hogg et al, 3 TCM 211; Hoffenbert v. Briggs, 84 USPQ 36.

[2] Diescher v. Comm. Int. Rev., 36 BTA 732.

Our professional inventor is not in such a fortunate position as the amateur inventor. This individual who spends all, or the majority of his time, in the obtaining of patents is faced with different problems. The court ruled in the case of Harold Avery [3] that the sale of patents by the professional inventor resulted in ordinary income and not a capital gain. In this case, Avery had procured 12 patents during a 17 year period, and had sold 3 of these patents and licensed 3 others. Although Avery had originally started his patent activities as a hobby on his spare time, the court said:

> "What may have been a hobby originally became a trade or business when he held the patents for sale or license to others for profit."

The Bureau of Internal Revenue has stressed this decision in later cases, but it appears that facts will have to be present to establish that the patents are held by an individual for sale as part of his ordinary business transactions in order to have the doctrine of the Avery case invoked.

In a very interesting article by Mr. Jay O. Kramer [4] concerning the sale of patents by professional inventors, the suggestion is made that a professional inventor should retain title to his less profitable inventions by issuing licenses, and report the royalties received as ordinary income. The inventor is then in a position to sell a more valuable patent and qualify such sale as a capital gain.

If the professional inventor is unable to avoid the ruling that the income received from the sale of his patent constitutes ordinary income, then we must attempt to find some other means to assist this inventor. Under Section 107(b), the professional inventor is allowed to spread the income received over a period of 3 years provided he has worked on the invention for at least 3 years, and so long as certain provisions are complied with.

The professional inventor can also take advantage of the provisions of Section 44 of the Internal Revenue Code regarding installment sales. Here the sale involves a fixed pre-determined price with an installment payment made each year. This allows the income to be spread over a number of years with a resulting tax gain.

Another method of securing relief for the professional inventor is through an exchange of the patent to a corporation for stock. This method is pointed out in an address given by Mr. Gustave Simons [5] to the New York Patent Law Association. Here, the exchange is a tax-free transaction, and when the stock is eventually sold, the resulting income is a capital gain.

Before leaving the subject of the sale of a patent, let us look

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[3] 47 BTA 538

[4] 31 Journal of the Patent Office Society 51.

[5] Tax Law of Research and Patents, 31 JPOS 574.

for a moment at the decision in the Myers [6] case. Here, the inventor granted an exclusive license to use, manufacture and sell the invention. Payments were designated as royalties and were to be paid annually. The licensor reserved the right to cancel the license in the event that the royalties failed to reach a specified yearly amount. The court held that the agreement was a sale even though the option was present, and the inventor allowed to treat the income as a long-term capital gain.

The Bureau of Internal Revenue does not acquiesce in this decision and issued a statement [7] setting forth the policy of the Bureau. Under this policy the Bureau would treat as ordinary income all amounts received by the inventor or owner of the patent under an assignment or a license providing for payments to be made, (1) in amounts measured by a fixed percentage of the selling price of the article manufactured and sold, (2) in amounts based by any other method upon production, sale or use, or, (3) in amounts payable periodically over the period in which the assignee or licensee uses the patent.

In spite of the statement, the tax court has followed the Myers case and ignored the policy established in holding later cases contra to the policy.[8] In connection with the Myers case, a study should be made of the *Waterman v. Mackenzie* [9] case which involves a similar type agreement, but the right to "use" the invention was omitted.

Assuming that we have established that a sale actually exists for both our amateur and professional inventor, we are now faced with the problem of establishing a value for the capital asset in order that the tax can be determined.

Under Regulation 111 of the Internal Revenue Code we find that the cost of developing patents should be capitalized.[10] This provision relating to Research Expense will be discussed in greater detail later in this paper. We also find under this regulation that the following costs, when actually paid, are allowable in determining the sum to be capitalized when a patent is obtained from the United States Government:

1. Various Government fees.
2. Development or experimental expenses.
3. Experimental models.
4. Costs of drawings.
5. Attorney's fees and similar expenses.

The provision in the regulation [11] provides as follows:

[6] Edward C. Myers, supra.

[7] Mimeo. 6490-1950-1CB9.

[8] H. W. Taylor, 16 TC 376 (non-acq.).

[9] 138 US 252.

[10] Gilliam Mfg. Co., 1 BTA 967; Goodell-Pratt Co., 3 BTA 30; Beaumont Co. v. Comm. Int. Rev., 3 BTA 822; Dempster Mill Mfg. Co. v. Burnet, 46 Fed. (2d) 604.

[11] Regulation 111, Sec. 29.23 (1) 8.

"If a taxpayer has incurred expenditures in his business for designs, drawings, patterns, models, or work of an experimental nature calculated to result in improvement of his facilities or his product, and if the period of usefulness of any such asset may be estimated from experience with reasonable accuracy, it may be the subject of depreciation allowances spread over the estimated period of usefulness."

Since a patent runs for a period of 17 years from the date of issuance, depreciation is allowable over the period of life. However, the basis for computation must be established sufficiently to allow the depreciation.[12] To digress for a moment, we also find that the regulations [13] allow an obsolescent deduction for patents in the amount of the depreciated cost of that part of the patent proved to be obsolete.[14] This permits the unamortized value to be charged off completely or in part to expense in any year where circumstances create a decline in value or complete loss of value to the patent owner. Besides obsolescence, court decisions holding the patent invalid, court injunctions against use of the patent, transfer of patent to an educational or other institution in good faith will allow the unamortized value to be expensed.

Returning now to our inventor, we find from the foregoing information that he would be required to capitalize the patent cost, determine the unamortized value, relate this value to the sale price, and then determine his tax on a long-term capital gain basis.

The majority of the preceding discussion has been related to the sale of a patent. Now the tax problems for other methods of handling the patent should be considered.

The most general method used by patent owners is the license agreement. By the use of a license agreement, the patent owner can retain control over his invention and also over improvements to his invention. As a general rule, royalties received from patent licenses are taxable as ordinary income under Section 22(a) of the Internal Revenue Code.[15] From the standpoint of the licensee of the patent, the royalties are treated as a deductible business expense.[16]

By retaining control of the patent through the use of a license agreement, the patent owner also is subjected to the possibility of litigation. This usually involves actions against the infringers of the patent, which may run several years before final settlement. If the patent holder is successful in such actions and recovers damages from the infringer, such payments are usually regarded as deferred income and treated as ordinary income for tax pur-

[12] Niagara Searchlight Co., 10 BTA 922.
[13] Regulation 103, Sec. 19.23(1) 7.
[14] Hazeltine Corp. v. Comm. Int. Rev., 89 Fed. (2d) 513.
[15] Ernest G. Hoffman, 8 BTA 1272.
[16] Regulation 111, Section 29.23 (a) 1.

poses. As suggested by Mr. Charles M. Hogan [17] in an excellent article concerning the Impact of Federal Income Taxation on Patent Law and Practice, it is advantageous to join a count for unfair competition and prove damage to the assets of the business. If such damages can be established, then the money paid as compensation for the injury to the asset is treated as ordinary income only to the extent that it exceeds the amount of the loss to the assets of the business.

When damages are finally recovered, the amounts should be included in the income tax return in the year in which they are received. Although the actual damages may have occurred several years before, it is not until the actual final accounting is made that the exact amount is determined.

The actual cost of the litigation against the infringers of the patent is a deductible expense provided the litigation does not perfect the title or prolong the life of the patent. The costs, which include court costs and counsel fees, can be deducted in the year incurred or at the close of the litigation proceedings. The losing party in such litigation is allowed to deduct the amount paid on the judgment.[18] In contrast to the allowance of these legal fees as deductible expenses, we find the amounts expended for legal services in connection with the prosecution of patent applications and interference proceedings in the Patent Office are treated as capital expenditures and not deductible expenses.[19] This is true even though some of the patent applications did not become issued patents.

The preceding discussion has mainly been directed to the field of patents. Although many of the provisions are the same for copyrights and trade-marks, there are certain differences in the handling of this type of intangible property that should be pointed out.

Copyrights, which are granted for a period of 28 years with the right to renew for an additional 28 year period, are subject to depreciation, and when sold; the gain or loss arising therefrom is computed by taking the difference between the selling price and the cost as established with proper adjustment for depreciation.

To a person in the profession of writing books or creating other artistic works, his income from the sale of the products of his work is taxed as ordinary income, and it matters not whether the income is in the form of royalties or proceeds from outright sale.

Two types of capital expenditures are found in the publication and sale of copyrighted books. In one case, the cost of producing and copyrighting the text may be returned to the holder through an annual allowance for depreciation, or if sold, the adjusted basis may be deducted from the sum received in deter-

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[17] 33 JPOS 531.
[18] Becker Bros. v. U. S., 7 Fed. (2d) 3.
[19] Hazeltine Corp. v. Comm. Int. Rev., supra.

mining the gain or loss from the sale. In the second case, where the author publishes a book, pays all publication costs and handles the sale of the books himself, he is allowed to allocate a proportionate share of the cost of each book and deduct this amount from the selling price in determining the amount to be reported as a profit and taxed as ordinary income.

Payments for limited rights in copyrighted works such as motion picture rights are treated as payments in the nature of royalties and taxed as ordinary income. The fact that the payments are made in lump sums does not change their status as royalties.[20] Motion picture rights are classified as property held primarily for sale rather than property used in a business, and therefore the sale of such rights results in ordinary income.

Passing to the field of trade-marks, we find we are dealing with property that has an indefinite duration. A trade-mark is granted by the Patent Office for a period of 20 years, and a renewal can be secured for each ensuing 20 year period. The courts have held that the inherent quality of trade-marks is such that they are not subject to exhaustion.[21] Other types of intangible property such as Goodwill, trade names, newspaper subscription lists and formulas are also not subject to a depreciation or obsolescent allowance because of the indefinite duration of their effective usefulness. It is only when the law makes the business worthless that this type of intangible property can properly be deducted as a loss.

The legal expenses incurred in prosecuting infringers of trademarks are capital expenditures which are added to the cost of the trade-mark and are not deductible expenses. A recent case [22] held that attorney's fees are not an allowable deduction where the fees were incurred in litigation to defend or perfect the title to a property right in a trade name. An amount paid to a company for permission to use a registered trade-mark is a capital expenditure and not an expense.

The problem of Research and Development Expense was briefly mentioned before and it was pointed out that the general rule is that these types of expenses should be capitalized. When they are capitalized they are amortized over the useful life of the project or over the 17 year life of the patent. If the project is abandoned, or if the patent becomes worthless, these expenses may then be written off in the year that such abandonment or obsolescence occurs. An excellent paper, previously mentioned, concerning this general problem was given by Mr. Gustave Simons.[23]

An important case[24] pertaining to the problem of handling

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[20] Comm. Int. Rev. v. P. G. Woodehouse, 337 U. S. 369.
[21] Norwich Pharmacal Co., 30 B.T.A. 326.
[22] Food Fair of Virginia, Inc. v. Comm. Int. Rev., 85 USPQ 518.
[23] Supra.
[24] Hart-Bartlett-Sturtevant Grain Co., 12 T.C. 101.

research expenses concerned contributions made to a Research Institute for vital research. The court held that these contributions were not deductible as current expenses and the following appeared in the opinion:

> It has been consistently held that expenses incurred in the experimentation and development of patents, formulas, and processes, are capital expenditures . . .
>
> It is not determinative of the issue here that nothing of a capital nature was developed during the taxable year in question or that the particular line of research which the Institute was following during that year subsequently proved fruitless. It is clearly the very nature of an experimental project that many lines of approach must be tried and many abandoned before results are obtained.
>
> Manifestly, the initial unsuccessful experiments as well as the final successful ones would have entered into the cost of any capital asset that had been developed. There was no occasion for saying at the close of the taxable year that no capital asset would be developed and for isolating the portion of the project sum expended by the Institute up until that time and deducting it as a business expense of petitioner. Clearly the project sum, which had been paid in toto by petitioner to the Midwest Research Institute shortly after the contract was executed, should be treated as a unit, like the project. As of the end of the taxable year on April 30, 1946, only slightly more than one-third of that project sum had been expended and only slightly more than one-fourth of the project time had elapsed. Only when the complete project had resulted in failure and there had been a definite abandonment or termination would the expenditures have been deducted, and then as a loss.

This case would seem to indicate that all research costs must be capitalized and that it is impossible to claim current expense deductions for these costs. This, however, is not the case, as the Bureau of Internal Revenue allows such expenses to be deducted as current expenses. The taxpayer, in order to qualify for such treatment, must follow a consistent practice in the handling of these expenses, and the amount spent in research must be approximately the same each year. This, of course, places a burden on new companies and also on small companies where the research expenses will vary widely from year to year.

The present policy of the Bureau of Internal Revenue is excellently stated in an article written by Mr. J. Keith Butters.[25]

> "By and large, the Bureau of Internal Revenue in its actual treatment of the handling of research and develop-

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[25] *Taxation and New Product Development*, Harvard Business Review, Summer 1945, p. 451.

ment expenditures has been much more liberal than the Treasury regulations would indicate and has generally permitted such expenditures to be deducted as current charges against net income.

The policy of the Bureau appears to be roughly as follows: If a firm spends approximately the same amount on research and development work year after year and consistently claims these expenditures as deductions from current income, it seldom has substantial amounts of its claims disallowed. On the other hand, if the amounts spent on research and development fluctuate widely from year to year and if the taxpayer does not follow a consistent accounting practice, the Bureau quite naturally tends to be more critical.

This policy sometimes results in a less favorable treatment for small, and also for new, companies than for large, established companies. The research expenditures of a small company operating in a field where research is important are likely to fluctuate more widely than those of a large company, and hence to be questioned more closely by the Bureau. A new company will frequently establish a precedent of capitalizing research and development expenditures in its early years in order to avoid reporting heavy losses and to make the best possible showing on its balance sheets. Such a precedent may later prove very damaging, but once it is established great difficulty is likely to be encountered in reversing it.

From the above, it can be seen that the Bureau is still following in practice the old provisions of the regulation which allowed the taxpayer to elect either a deduction for the research expenses in the year incurred or to treat the expenses as a capital asset. It must be recognized that a serious challenge from the Bureau to the present operating practice of a concern will probably result in the expenditures being capitalized.

In closing, it can be readily seen that the taxation problems involving intangible property are many and varied. It is only through the close cooperation of the legal profession and the accounting profession that the proper solutions may be uncovered, and the interests of the owner of such property be fully protected.

ON THE PRUDENT MAN RULE

In the Matter of the Estate of John Joseph Jacobs, No. 60051, Judge Brofman ruled that, in the absence of language in the will to the contrary, a fiduciary may make investments under the "prudent man rule," Chap. 297, L. 1951 (Section 126, Chap. 176, '35 C.S.A.), notwithstanding the fact that the preparation of the instrument and the death of the testator were prior to the enactment date of the legislation adopting the "prudent man rule."