

Personal Income Tax-Capital Gains on Sales to Controlled Corporations-Section 1239 Not Applicable to Transfers of Patent Applications

Leslie D. Locke

Follow this and additional works at: <http://scholarship.law.cornell.edu/clr>

 Part of the [Law Commons](#)

Recommended Citation

Leslie D. Locke, *Personal Income Tax-Capital Gains on Sales to Controlled Corporations-Section 1239 Not Applicable to Transfers of Patent Applications*, 60 Cornell L. Rev. 131 (1974)
Available at: <http://scholarship.law.cornell.edu/clr/vol60/iss1/6>

This Article is brought to you for free and open access by the Journals at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Review by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

RECENT DEVELOPMENTS

Personal Income Tax—CAPITAL GAINS ON SALES TO CONTROLLED CORPORATIONS—SECTION 1239 NOT APPLICABLE TO TRANSFERS OF PATENT APPLICATIONS

Lan Jen Chu v. Commissioner, 486 F.2d 696 (1st Cir. 1973)

1

CAPITAL GAINS AND DEPRECIATION—DOUBLE TAX BENEFIT

By transferring a capital asset to a corporation which he controls, the transferor may reap substantial federal income tax benefits if the transferred property is depreciable in the hands of the corporation. These benefits result from two factors: the favorable tax rates applied to gains on sales and exchanges of capital assets,¹ and depreciation deductions which the corporation can take against the stepped-up basis of the transferred property.²

Assume, for example, that an individual who pays federal income tax at the rate of fifty percent holds a patent which qualifies as a capital asset³ pursuant to section 1221 of the Internal Revenue

¹ INT. REV. CODE OF 1954, §§ 1201, 1202, 1221, 1222.

In the case of an individual, long-term capital gain (*see* note 6 *infra*) is taxed according to one of two statutory provisions. Under § 1202 of the Code, 50% of the excess of net long-term capital gain over net short-term capital loss is deducted from gross income, leaving only the remaining 50% to be taxed at ordinary rates.

Where it produces a lesser tax, the "alternative" method outlined in § 1201 is used. Section 1201(b) imposes a 25% tax on the excess of net long-term capital gain over net short-term capital loss ("net § 1201 gain"), but, except for the transitional provisions contained in §§ 1201(d)(1) & (2), this 25% rate applies only to that part of such gain not exceeding \$50,000 (or \$25,000 in case of a married individual filing a separate return). Effectively, the tax on "net § 1201 gain" in excess of \$50,000 is computed under § 1201(c) as if the basic (§ 1202) method applied. Thus, an effective rate as high as 35% (including the minimum tax for tax preferences, §§ 56-58, the rate may actually be as high as 40%) may apply to such excess (*i.e.*, applying the maximum rate on individuals of 70%, § 1(c), to 50% of the excess gain).

Unless otherwise indicated, all references are to the Internal Revenue Code of 1954.

² INT. REV. CODE OF 1954, § 167 (providing deduction from gross income for depreciation of property used in trade or business or held for production of income).

³ Interestingly, other products of the mind, such as copyrights, literary, musical and artistic works, letters or memoranda, "or similar property" in the hands of the creator, are specifically excluded from the definition of "capital asset." INT. REV. CODE OF 1954, § 1221(3)(A). The House version of this subsection's predecessor in the 1939 Code would have excluded patents held by inventors from this definition. *See* note 79 *infra*.

Code of 1954. Rather than market the invention himself and pay a fifty percent federal income tax on the proceeds,⁴ the patent holder sells the patent to his wholly owned corporation.⁵ In return the corporation agrees to pay the transferor/shareholder fifteen percent of the gross price of each unit sold. If the transferor has held the patent longer than six months,⁶ his royalty-like receipts from the corporation will be treated as long-term capital gain and will be taxed at an effective rate of twenty-five percent.⁷ Although the corporation will not enjoy the benefits of the fifteen percent it must pay to its shareholder, it will not pay tax⁸ on this portion of income from sales of the invention because during the seventeen year life of the patent the corporation may deduct as depreciation the amount paid for the patent.⁹ Thus, the patent holder retains effective control over the marketing of the invention while avoiding a considerable portion of the tax burden which would accompany such marketing if he were to undertake it personally.

In order to restrict this practice and halt the abuse inherent in transactions among separate entities which nevertheless comprise a single economic unit,¹⁰ Congress enacted section 117(o) of the

⁴ INT. REV. CODE OF 1954, §§ 1, 61(a)(2).

⁵ The example refers to the transferor's wholly owned corporation for simplicity. While it is true that at one time an individual could claim a capital gain on sales of depreciable property to a wholly owned corporation, the transferor's or transferee's interest in the transferee or transferor corporation was limited to 80% in 1951 by the passage of § 117(o) of the 1939 Code. Revenue Act of 1951, Pub. L. No. 183, ch. 521, § 328(a), 65 Stat. 504. Section 1239(a)(2) of the 1954 Code continues this limitation. See note 11 and accompanying text *infra*.

⁶ "The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months . . ." INT. REV. CODE OF 1954, § 1222(3). Gain from the sale of capital assets held for less than 6 months—short-term capital gain—is taxed at ordinary rates. See INT. REV. CODE OF 1954, §§ 1201, 1202.

⁷ This rate assumes a 50% tax rate on ordinary income and no offsetting capital losses. Since § 1202 provides a deduction from gross income of 50% of the excess of net long-term capital gain over net short-term capital loss, the taxpayer will pay a tax at his ordinary rate of 50% on only one-half of his net capital gain, *i.e.*, an effective rate of 25% on his total net capital gain.

⁸ Sections 11(b)(2) and (c)(3) of the Code provide respectively for a corporate income tax on taxable income of 22% plus a surtax of 26% on taxable income exceeding the amount of the "surtax exemption," for an effective tax rate of 48% on all taxable income above the amount of the surtax exemption. INT. REV. CODE OF 1954, §§ 11(b)(2), (c)(3). At present the surtax exemption is \$25,000. *Id.* § 11(d).

⁹ INT. REV. CODE OF 1954, § 167. Treas. Reg. §§ 1.167(a)-3, (a)-6. When a patent expires it has no value, and therefore no salvage value, so that depreciation can be taken in an amount equal to the entire purchase price.

¹⁰ As one court pointed out,

[by] 1949 the corporate rates of tax, under the Internal Revenue Code of 1939, as amended, had been raised substantially in excess of capital gains rates. Any small group of persons organizing a corporation could obtain a stepped-up basis on property sold to the corporation for the purpose of depreciation against a 52% tax

Internal Revenue Code of 1939, now section 1239 of the 1954 Code.¹¹ This section provides that in the case of a sale or exchange of depreciable property between a husband and wife, or between an individual and a corporation where the individual directly or indirectly holds more than eighty percent of the stock, any resulting gain shall be treated as ordinary income.

II

Lan Jen Chu v. Commissioner

In *Lan Jen Chu v. Commissioner*,¹² however, the United States Court of Appeals for the First Circuit exposed a significant inadequacy in section 1239 of the Code. Lan Jen Chu, a professor at the Massachusetts Institute of Technology and "an eminent authority on electromagnetic theory and antenna systems,"¹³ during the summer of 1956 had filed with the United States Patent Office an

rate or even a 90% excess profits tax rate at a cost to the stockholder sellers of only the 25% capital gains tax rate on the gain on the sale of the property to a corporation. The Commissioner of Internal Revenue requested remedial legislation of the United States Congress

Sarkes Tarzian, Inc. v. United States, 159 F. Supp. 253, 256 (S.D. Ind. 1958).

¹¹ § 1239. Gain from sale of certain property between spouses or between an individual and a controlled corporation

(a) Treatment of gain as ordinary income.

In the case of a sale or exchange, directly or indirectly, of property described in subsection (b)—

(1) between a husband and wife; or

(2) between an individual and a corporation more than 80 percent in value of the outstanding stock of which is owned by such individual, his spouse, and his minor children and minor grandchildren;

any gain recognized to the transferor from the sale or exchange of such property shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(b) Section applicable only to sales or exchanges of depreciable property.

This section shall apply only in the case of a sale or exchange by a transferor of property which in the hands of the transferee is property of a character which is subject to the allowance for depreciation provided in section 167.

(c) Section not applicable with respect to sales or exchanges made on or before May 3, 1951.

This section shall apply only in the case of a sale or exchange made after May 3, 1951.

INT. REV. CODE OF 1954, § 1239. Section 1239 of the Internal Revenue Code of 1954 is substantially identical to § 117(o) of the Internal Revenue Code of 1939. See S. REP. NO. 1622, 83d Cong., 2d Sess. 444 (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. A286 (1954).

The Technical Amendments Act of 1958, § 56, 72 Stat. 1645, amended 26 U.S.C. § 1239 by adding subsection (c) to indicate that § 1239 applied "only in the case of a sale or exchange made after May 3, 1951," to coincide with the date when the earlier provision, § 117(o) of the 1939 Code, came into effect.

¹² 486 F.2d 696 (1st Cir. 1973), *aff'g* 58 T.C. 598 (1972).

¹³ *Id.* at 697.

application for a patent¹⁴ on a completely enclosed antenna system. The application consisted of eighteen different claims.¹⁵ Claims 1-13 represented the heart of the invention while claims 14-18 pertained to an alternative design of lesser potential marketability. In 1957 the Patent Office replied that claims 14-18 appeared to be allowable,¹⁶ but that claims 1-13 were disallowed. Two amendments to the original application were subsequently filed, but the only change reflected in Patent Office replies was that along with claims 14-18, claim 12 similarly appeared to be allowable. Meanwhile in August 1959, Chu Associates, Inc. was formed for the purpose of manufacturing antennas. At the time of incorporation, Chu held eighty-nine percent of the issued shares.

In December 1959 Chu assigned his entire interest¹⁷ in the patent application¹⁸ to the corporation in exchange for \$2,000

¹⁴ A patent is statutorily defined as "a grant to the patentee, his heirs or assigns, for the term of seventeen years . . . of the right to exclude others from making, using, or selling the invention throughout the United States." 35 U.S.C. § 154 (1970).

A patent application is "a petition to the Commissioner of Patents to grant letters patent to the inventor on the basis of the facts disclosed in the application, especially in that section of it known as the Specifications." M. DOCK & W. SANDERSON, *A FORTUNE IN YOUR HEAD* 16 (1963). It is among "the most difficult legal instruments to draw with accuracy." *Sperry v. Florida*, 373 U.S. 379, 383 (1963), quoting *Topliff v. Topliff*, 145 U.S. 156, 171 (1892). Included in the patent application must be "a drawing (except in chemical cases); a detailed description and specification . . . and one or more claims which legally define and limit the precise scope of the invention." R. BUCKLES, *IDEAS, INVENTIONS AND PATENTS* 82 (1957). The specification and oath or declaration must be in English. 37 C.F.R. § 1.52 (1973). Ink, paper, margins, and page numbering are specified by regulation and all interlineations and other alterations must be verified. *Id.*

¹⁵ The claims are of prime importance in a patent application:

[The] definitions of the invention, which the solicitor prepares, become the claims of the patent application. The claims, when allowed by the Patent Office, are the very heart of the issued patent. The patent claims define the area of activity from which the patent owner may exclude everyone else, so they are the feature of the patent which gives it value to the owner.

R. BUCKLES, *supra* note 14, at 80.

The drafter's art is to disclose as little as possible in the claims while drawing the broadest claims possible. *Brenner v. Manson*, 383 U.S. 519, 534 (1966).

¹⁶ The Patent Office informs the applicant formally of allowability in a notice of allowance. 37 C.F.R. § 1.311 (1973). After the notice of allowance has been sent the application will not be "withdrawn from issue" except for mistake of the Patent Office, fraud or other illegality in the application, or for "interference." 37 C.F.R. § 1.313(b) (1973). When the applicant pays the issue fee the patent will issue "in regular course." 37 C.F.R. § 1.314 (1973).

¹⁷ Rights to the patent were jointly held by Chu and his colleague, Ivan Faigen, in interests of 11/12 and 1/12 respectively. Prior to the assignment to Chu Associates, Inc., Faigen assigned his 1/12 interest to one Rines. The payments received from the transferee corporation, therefore, were to be divided between Rines and Chu in proportion to their respective interests.

¹⁸ The assignability of patent applications is recognized in 37 C.F.R. § 1.331 (1973). The assignee of record is entitled to conduct the prosecution of the application to the

payable immediately, \$60,000 to be paid in 1960, and fifteen percent of the gross selling price of every antenna system manufactured and sold by the corporation in each year thereafter, subject to a minimum \$15,000 annual payment. Subsequent to the assignment, a third amendment to the patent application was filed,¹⁹ this time with success. The Patent Office allowed all claims and on May 30, 1961, a patent was issued to the assignee corporation. In his income tax returns for the years 1962 through 1965 Chu reported as long-term capital gain \$250,000 which he had received in annual payments for the assignment of the patent application to Chu Associates, Inc. The Internal Revenue Service asserted a deficiency, claiming that since Chu owned more than eighty percent of the assignee corporation's stock, any gain arising from the patent assignment had to be treated as ordinary income pursuant to section 1239 of the Code.²⁰

exclusion of the inventor, 37 C.F.R. § 1.32 (1973), and the patent will normally issue to the assignee. 37 C.F.R. § 1.334 (1973). But, with certain exceptions, such as refusal, the inventor himself must execute the application. 35 U.S.C. § 102(f) (1970); 37 C.F.R. § 1.46 (1973). When the situation fits within one of these exceptions to the general rule, an assignee may make the application for patent. 35 U.S.C. § 118 (1970). If the invention appears to be patentable and commercially exploitable, sound reasons point to beginning commercial exploitation prior to patent issuance:

If the firm marks the products "Pat. Pending," or "Patent Applied For," competitors may be discouraged from copying the invention, so that in practical effect the period of the patent term may be extended during the time that the application is pending. . . . [S]uch patent marking does not constitute a legal bar . . . [but] in most cases competitors will not wish to risk a substantial investment . . . knowing that their program may be legally interrupted as soon as the patent issues.

R. BUCKLES, *supra* note 14, at 98.

¹⁹ It appears that the extended period between initial application and award of patent experienced here is the rule. "The average patent application remains pending in the Patent Office for three or four years before the patent issues . . ." R. BUCKLES, *supra* note 14, at 98.

Aside from the obvious magnitude of the Patent Office's task in searching the already-known state of the art to determine whether the claimed invention is really something novel, another cause of delay is the extensive interchange between the Patent Office and the applicant. The applicant (or more likely the applicant's patent attorney) makes claims as broad as possible. *See* note 15 *supra*. The Patent Office examiner, on the other hand, requires that claims be narrowly stated. The claims which are novel and patentable or which are anticipated by the prior art and finally rejected are in effect distilled out by a process of amendment by the applicant and rejection by the examiner. *Lear, Inc. v. Adkins*, 395 U.S. 653, 658 (1969).

²⁰ In this case the patent application was transferred five months after formation of the corporation. In a proper case—*i.e.*, where formation of the corporation and transfer of property take place almost simultaneously—the IRS could make an argument based upon § 351 of the Code for disallowing capital gains treatment. That section operates to defeat capital gains treatment on the transfer of property to a corporation where after the transfer the transferor has control of the corporation. Section 351(a) provides that "[n]o gain or loss shall be recognized if property is transferred to a corporation . . . solely in exchange for stock or securities in such corporation and immediately after the exchange [the transferor is] . . . in control . . . of the corporation." The corporation takes the transferor's basis in the

Both the Tax Court²¹ and the First Circuit²² rejected the Commissioner's deficiency claim, but in neither court did the decision turn on the IRS contention that Chu was foreclosed by section 1239(a)(2) from claiming a long-term capital gain because he owned "more than 80% in value of the outstanding stock" of the assignee.²³ Instead, the decision turned on section 1239(b), which requires that the transferred property be "of a character which is subject to the allowance for depreciation" in the hands of the transferee. The court of appeals said that "[t]here can be no doubt that, in general, patent applications are not depreciable property."²⁴ The government argued that since the statute applied to "property of a character subject to depreciation" the statute should be construed so as to apply not only to depreciable property "but also to the transfer of property of the type which might ultimately become depreciable."²⁵ The court of appeals rejected this liberal interpretation of the statute, finding that such a con-

property exchanged, which in the case of a patent may be zero, so that the overall effect would be to negate completely the desired tax advantage. The transferor would get no capital gains advantage and the corporation would have no stepped-up basis in the property for depreciation purposes.

According to one observer,

[i]f the requirements of section 351 are otherwise met, and the "seller" seeks to avoid that section simply by forming the corporation in a section 351 transfer and shortly thereafter "selling" the property to the newly-formed corporation, the Commissioner should have little difficulty in showing that the later sale was an integral part of the corporation's formation, so that the two steps (organization and sale) were effectively a single section 351 transfer.

Ellis, *Tax Problems in Sales to Controlled Corporations*, 21 VAND. L. REV. 196, 206-07 (1968) (citing *Labrot v. Burnet*, 57 F.2d 413 (D.C. Cir. 1932)). *But see Sarkes Tarzian, Inc. v. United States*, 159 F. Supp. 253, 257 (S.D. Ind. 1958) (describing unsuccessful attempt to apply forerunner of § 351, § 112(b)(5) of 1939 Code, in situation where patent applications were transferred to wholly owned corporation).

²¹ 58 T.C. 598 (1972).

²² 486 F.2d 696 (1st Cir. 1973).

²³ If Chu had held precisely 80% of the corporation's stock it is open to question whether he would have avoided the reach of § 1239(a)(2). While that section literally applies only where an individual owns "more than 80% in value" of the transferee's or transferor's capital stock, the language has been liberally interpreted in at least one case. The transferor held precisely 80% of the corporate transferee's stock in *United States v. Parker*, 376 F.2d 402 (5th Cir. 1967), but the court nevertheless applied § 1239. Although the taxpayer owned only 80% in *number* of shares, the court held that because of restrictions on the remaining shares this stock represented more than an 80% interest in *value*. See Ellis, *supra* note 20, at 201.

²⁴ 486 F.2d at 702 (citing *United States Mineral Products Co.*, 52 T.C. 177 (1969); *Hershey Mfg. Co.*, 14 B.T.A. 867, *aff'd*, 43 F.2d 298 (10th Cir. 1930)).

²⁵ 486 F.2d at 700.

struction was supported neither by the statutory language²⁶ nor by the legislative history.²⁷

The IRS made the alternative argument that Chu's patent applications were sufficiently "matured" to be treated as issued patents for purposes of section 1239 according to the standards enunciated in a Seventh Circuit decision, *Estate of Stahl v. Commissioner*,²⁸ and that, therefore, capital gain was improperly claimed. Although declining to endorse the *Stahl* "maturity" distinction, both the Tax Court and the Court of Appeals for the First Circuit nevertheless found it inapplicable on the facts since "[n]ot only had no Notice of Allowance been granted on his application at the time of transfer, but the primary claims of that application had been thrice rejected."²⁹ Therefore, the patent applications were not "matured" as were their counterparts in *Stahl*.

²⁶ *Id.* The court noted that the section's caption, "Section applicable only to sales or exchanges of depreciable property," evidenced the congressional scheme.

²⁷ *Id.*

²⁸ 442 F.2d 324 (7th Cir. 1971), *aff'g in part* 52 T.C. 591 (1969). In *Stahl* the taxpayer had sold to his wholly-owned corporation all his interest in eight patents and five patent applications in return for 15 notes in the principal amount of \$300,000, one note to mature each year over a 15 year period. *Stahl* reported his income from the sale as long-term capital gain. The IRS asserted a deficiency based on § 1239 of the Code, claiming the gain was ordinary income. The Tax Court agreed with the IRS that income from that part of the sale attributable to patents was indeed ordinary income under § 1239. As to income derived from sale of the patent applications, however, the Tax Court held that, unlike patents, patent applications are not "property 'of a character' which is subject to the allowance for depreciation within the purview of section 1239(b)." 52 T.C. at 600.

On appeal the Seventh Circuit partly reversed the Tax Court and broadened the coverage of § 1239 by distinguishing patent applications which had been the subject of a notification of allowability from the Patent Office from applications which had been initially rejected or on which the Patent Office had given no indication of intended disposition. The patent applications in the former category, the court said, "were sufficiently matured . . . as to require that they be treated as patents for purposes of section 1239." 442 F.2d at 328.

Although in *Stahl* the Seventh Circuit had applied § 1239 to gain realized on the transfer of a patent application about which the Patent Office had merely noted that some claims "appear[ed] allowable," (442 F.2d at 328), the First Circuit, deciding this same question with regard to claims 12 and 14-18 in *Chu* (*see* notes 15 & 16 and accompanying text *supra*) held § 1239 inapplicable. The court said that "in the instant case claims 1-13 were the 'heart' of the patent, and until they had been declared 'allowable,' the application as a whole must in substance be regarded as having been rejected." 486 F.2d at 703.

²⁹ 486 F.2d at 703.

Lan Jen Chu has been followed in a similar case by the Court of Appeals for the Sixth Circuit. In *Davis v. Commissioner*, 491 F.2d 709 (6th Cir. 1974) (*per curiam*), a notice of allowance was sent ten months after the taxpayer had sold all his rights in an invention to his controlled corporation. A patent was issued shortly thereafter. The IRS unsuccessfully argued that the patent application was sufficiently matured at the time of sale to be treated as depreciable property for purposes of § 1239, citing *Estate of Stahl v. Commissioner*, 442

Given a transfer of patent rights between a corporation and an individual when the more-than-80%-interest provision of section 1239(a)(2) is met, *Lan Jen Chu* shows that the tax consequences will vary depending on the occurrence of an event which is largely inconsequential in its tax implications: the granting of a patent. If the rights are embodied in a patent, the transferor will realize ordinary income. If the rights are not yet embodied in a patent (or if the patent application is not sufficiently "matured" according to *Stahl*) the transferor will realize capital gain. The court of appeals recognized the implications of their holding:

Unless § 1239 is interpreted as the government suggests, a significant loophole could be created in the application of that section. It would be a simple matter for a tax conscious inventor to sell his pending application to a controlled corporation, pay capital gains on the excess of the purchase price over his basis, and then, once the application has been approved, allow the corporation to write-off against ordinary income, depreciation on the now stepped-up basis of the patent.³⁰

III

CLOSING THE BREACH—SECTION 1239

A. *Applicability of the Depreciation Allowance to Patent Applications*

Section 117(o) of the 1939 Code (now section 1239 of the 1954 Code³¹) was enacted by Congress in 1951 in order to restrict the double tax benefits that resulted from a transfer of depreciable property within a single economic unit.³² Patent transfers were

F.2d 324 (7th Cir. 1971). In affirming the Tax Court, the court of appeals cited *Stahl* for the proposition that a patent application subject to a notice of allowance is within § 1239, and *Lan Jen Chu* for the proposition that this patent application was not depreciable and therefore not subject to § 1239. The court recognized that the purpose underlying § 1239 is defeated in this kind of situation:

It is asserted that the legislative intent behind § 1239 was to prevent situations in which a taxpayer sells appreciated property at current market prices to his controlled corporation and thus, while keeping control over the property, reaps the benefits of both capital gains treatment for himself and depreciation deductions against ordinary income in his controlled corporation. Unquestionably this was done in the present case. This points up another tax loophole in the Internal Revenue Code. It is our view that only Congress can plug that loophole.

491 F.2d at 710.

³⁰ 486 F.2d at 700.

³¹ See note 11 *supra*.

³² See H. R. REP. NO. 586, 82d Cong., 1st Sess. (1951); S. REP. NO. 781, 82d Cong., 1st Sess. (1951). Section 1239 of the 1954 Code is virtually identical to its predecessor, § 117(o) of the 1939 Code. See note 11 *supra*.

The statute has been criticized for its omission of non-depreciable property. The sale to a controlled corporation of a non-depreciable asset with a stepped-up basis offers the

intended to come within the statute's scope.³³ This section will explore the applicability of depreciation to patents and patent applications in examining the premise in *Lan Jen Chu* that patent applications are not depreciable. Solutions for closing the section 1239 gap will be suggested.

It is a general rule that no allowance for depreciation will be permitted unless the property has a "limited and determinable existence."³⁴ Because the life of an intangible asset can rarely be determined with any certainty, it is more difficult to depreciate than a tangible asset.³⁵ Thus, such intangibles as "goodwill, trade names, trade brands, newspaper subscription lists, formulae, and rights to receive royalties on copyrighted books are not ordinarily subject to depreciation . . ."³⁶ A patent, although an intangible, does have an ascertainable life of seventeen years, and it is due to this certainty that patents qualify for the depreciation allowance.³⁷ A patent application on the other hand has no definite life, since it may remain an application indefinitely until a patent is issued or finally rejected, or the applicant abandons his attempt to obtain a patent.³⁸ Treasury Regulation section 1.167(a)-3, although not specifically mentioning patent applications, suggests that a patent application does not qualify for depreciation since it appears to fall within the category of "[a]n intangible asset, the useful life of which is not limited . . ."³⁹ On the other hand, Revenue Ruling 67-136

transferor the same tax benefit as the sale of an asset on which the corporation can take deductions for depreciation:

The purpose of enacting section 1239 was to prevent the corporation from obtaining a stepped-up basis against which future depreciation deductions could be taken, while the seller paid only a capital gains tax on the sale. Since land is not depreciable, . . . the statute was made inapplicable to land. This is somewhat surprising since essentially the same tax advantages which section 1239 seeks to deny can be obtained if land suitable for development is sold to a controlled corporation. The corporation can develop and sell the land, using the stepped-up basis to offset ordinary income received on the sales.

Ellis, *supra* note 20, at 200.

³³ See, e.g., S. REP. No. 781, 82d Cong., 1st Sess. 69 (1951), (patent transfer illustrates section's effect).

³⁴ See Treas. Reg. § 1.167(a)-3 (1956); 4 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 23.12, at 70 (1973 ed.).

³⁵ 4 J. MERTENS, *supra* note 34, § 23.10, at 49.

³⁶ *Id.* at 53.

³⁷ See Treas. Reg. § 1.167(a)-6(a) (1956) (cost or other basis of patent depreciable over remaining useful life).

³⁸ See note 46 *infra*.

³⁹ Treas. Reg. § 1.167(a)-3, T.D. 6452, 1960-1 CUM. BULL. 123.

The Internal Revenue Service has argued both sides of the question at various times. Compare *Best Lock Corp.*, 31 T.C. 1217 (1959) (IRS claims patent rights nondepreciable prior to patent issuance), and *Century Tank Mfg. Co.*, 18 T.C.M. 430 (1959) (IRS claims

states that "patent applications relating to inventions on which a patent will be issued in the normal course are depreciable."⁴⁰ Unfortunately, the Revenue Ruling does not elaborate on the phrase, "issued in the normal course." It seems likely, however, that this phrase refers to patent applications which are the subject of a notice of allowance. After a notice of allowance has been communicated to the applicant by the Patent Office and the issue fee paid, a patent will issue "in regular course" unless one of a group of specified issues develops.⁴¹

It is consistent with the majority of Tax Court decisions⁴² and the position of the IRS in general that the IRS did not argue in *Lan Jen Chu* simply that patent applications are depreciable. Rather, it argued that since section 1239 applies to "property of a character which is subject to the allowance for depreciation," therefore "the limitations on capital gain treatment imposed by that section apply not only to the sale or exchange of depreciable property, but also to the transfer of property of the type which might ultimately become depreciable."⁴³ By refraining from arguing that patent applications are per se depreciable, the IRS apparently wanted to occupy a middle position, avoiding a direct challenge to the traditional notion that patent applications are nondepreciable, while at the same time maintaining that, under certain circumstances, patent applications are so similar to depreciable property that the restraints of section 1239 should apply.

In general, patent applications fail to meet the requirements for depreciability because of their unpredictable duration. Nevertheless, for some patent applications the deduction for deprecia-

patent applications not subject to depreciation), with *Lan Jen Chu*, 58 T.C. 598 (1972), *aff'd*, 486 F.2d 696 (1st Cir. 1973) (IRS claims patent application "property of the nature contemplated by section 1239"), *Estate of William F. Stahl*, 52 T.C. 591 (1969), *aff'd in part*, 442 F.2d 324 (7th Cir. 1971) (IRS claims § 1239 should apply to proceeds from sale of patent applications), and *Benjamin I. Davis*, 31 T.C.M. 1155 (1972), *aff'd*, 491 F.2d 709 (6th Cir. 1973) (IRS claims § 1239 applicable to patent application transfers).

⁴⁰ Rev. Rul. 67-136, 1967-1 CUM. BULL. 58.

⁴¹ See note 16 *supra*.

⁴² The Tax Court has not maintained a consistent position on the depreciability of patent applications. Thus, in *Julian A. McDermott*, 41 T.C. 50 (1968), *Best Lock Corp.*, 31 T.C. 1217 (1959), and *John A. Nelson Co.*, 28 B.T.A. 529 (1933), *aff'd*, 75 F.2d 696 (7th Cir. 1935), *rev'd on other grounds*, 296 U.S. 374 (1935), the Tax Court either held or stated as dictum that patent applications are depreciable. The majority of Tax Court decisions, however, have held patent applications non-depreciable. See, e.g., *United States Mineral Prods. Co.*, 52 T.C. 177 (1969); *International Cigar Machinery Co.*, 36 B.T.A. 124 (1937); *Hershey Mfg. Co.*, 14 B.T.A. 867 (1928), *aff'd*, 43 F.2d 298 (10th Cir. 1930); *Individual Towel & Cabinet Service Co.*, 5 B.T.A. 158 (1926).

⁴³ 486 F.2d at 700 (emphasis in original).

tion seems appropriate. The IRS apparently accepts this view when the issuance of a patent is certain enough that the life of the patent application can be estimated with reasonable accuracy.⁴⁴ In his concurring opinion in *Lan Jen Chu*, Judge Campbell was impressed by the fact that “[p]atent applications represent the same underlying *res*—the invention—as do patents . . . both waste; both are, in theory if not in fact, depreciable.”⁴⁵ Like patents, patent applications fit the broad guidelines of section 167(a) allowing a depreciation deduction. They are subject to “exhaustion, wear and tear”⁴⁶ and are used “in the trade or business” or “for the production of income.”⁴⁷ Even without reference to an ascertained useful life, the annual depreciation deduction could be determined by reference to the annual royalties paid on the purchase price where this manner of payment is used.⁴⁸ Specific regulations for determining

⁴⁴ See Rev. Rul. 67-126, 1967-1 CUM. BULL. 58; note 40 and accompanying text *supra*.

⁴⁵ 486 F.2d at 705 (concurring opinion).

⁴⁶ Patent applications are exhaustible in at least three ways. First, as representative of the underlying invention, the application has value only so long as the invention has value. The march of technology today may overtake and render obsolete yesterday's innovation. Second, the application itself may “wear out.” After a process of rejection by the Patent Office and amendment by the applicant, the patent examiner may conclude that none of the claims are patentable and issue a final rejection. See *Lear, Inc. v. Adkins*, 395 U.S. 653, 658 (1969); 37 C.F.R. § 1.113 (1973). The applicant must either cancel each finally rejected claim or appeal from the rejection of each. 37 C.F.R. § 1.113 (1973). Third, an application may simply be abandoned. The applicant must respond within six months after an official notice from the Patent Office, or within a shorter period if so fixed by the Commissioner of Patents. 37 C.F.R. § 1.135(a) (1973). If he fails to respond within the designated time, the application is considered abandoned. *Id.*

⁴⁷ INT. REV. CODE OF 1954, § 167(a).

⁴⁸ In *Associated Patentees, Inc.*, 4 T.C. 979 (1945), three inventors and an investor pooled their various patent rights on an equal share basis and formed a corporation to which the four shareholders assigned their patent rights. The corporation licensed a third party to use some of these patents in return for which the corporation was to receive a royalty equal to 5% of the gross sales price of products manufactured under the license. In turn, each of the four shareholders was to receive a royalty from their licensor corporation of 20% of all royalties it received. The licensor corporation tried to deduct its own royalty payments to its four shareholders as a normal business expense, but the Commissioner asserted a deficiency which was upheld by the Tax Court on the grounds that the royalty payments did not represent expenses but rather the cost of acquiring capital assets.

On rehearing to determine the amount of depreciation allowable to this Corporation, the Tax Court held that the total cost of the patents over their lives was depreciable. The Tax Court recognized that due to the method of payment, a determination as to the final cost of the patent to the licensor corporation was impossible at that time and therefore, the ordinary method of computing depreciation by proration of the total cost over the expected life of the asset was impossible.

Pointing out that § 23(I) of the 1939 Code (now § 167(a) of the 1954 Code) provided for a “reasonable allowance,” and required no specific method for computing depreciation, the Tax Court held that the method used by the petitioner corporation, whereby it deducted its annual royalty payment to its assignors as depreciation, was reasonable. 4 T.C. at 986.

depreciation in such cases might be promulgated, thereby bringing this inchoate property squarely within section 1239 of the Code.⁴⁹ Considering the magnitude of such a change, potentially affecting any patent application, relative to probably fewer instances where section 1239 will be avoided in the *Lan Jen Chu* fashion, such a remedy perhaps appears less desirable to the IRS than retaining an imperfect status quo. But this drastic shift is not required, for more practicable reform measures exist.

B. *Judicial Solution*

One approach to reform was demonstrated by the Seventh Circuit in the *Stahl* decision,⁵⁰ which extended the reach of section 1239 by treating "mature" patent applications as patents.⁵¹ The *Stahl* extension of section 1239 is supported by the statutory language "of a character . . . subject to the allowance for depreciation,"⁵² which invites a liberal construction. And perhaps most importantly, *Stahl's* limited extension of section 1239 to patent applications seems to carry out this section's underlying legislative purpose to restrict tax benefits resulting from sales of capital assets among related parties.⁵³

As a permanent device to plug the section 1239 loophole, however, the significance of *Stahl* is limited by easy avoidance. In

(Section 167(b) of the 1954 Code, a section enacted since the date of the cited case, does provide for the "use of certain methods and rates" but these methods are not exclusive.) The IRS has approved the method of calculating depreciation used in *Associated Patentees*. See Rev. Rul. 67-136, 1967-1 CUM. BULL. 58.

⁴⁹ The Code provides general authority for the Secretary of the Treasury to "prescribe all needful rules and regulations for the enforcement" of the Code. INT. REV. CODE OF 1954, § 7805. The provision has been liberally interpreted. In *Bingler v. Johnson*, 394 U.S. 741 (1969), the Court indicated the breadth of the power. Plaintiffs were employed by Westinghouse Electric Corp. and participated in a fellowship program in one phase of which qualified employees devoted full time to their dissertations and received a stipend from Westinghouse ranging from 70% to 90% of their prior salaries. Plaintiffs contended the stipend was a scholarship and therefore excludable pursuant to § 117 of the Code. The IRS relied upon Treasury Regulation § 1.117-4(c) in determining that the stipends represented compensation and were not excludable.

In reversing the Court of Appeals for the Third Circuit and upholding the regulation against plaintiff's attack, the Supreme Court quoted a previous decision:

[T]he Regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes," and "should not be overruled except for weighty reasons."

Bingler v. Johnson, 394 U.S. 741, 750 (1969), quoting *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948).

⁵⁰ 442 F.2d 324 (7th Cir. 1971). See note 28 *supra*.

⁵¹ See note 28 *supra*.

⁵² INT. REV. CODE OF 1954, § 1239(b) (emphasis added).

⁵³ See note 32 and accompanying text *supra*.

many situations, such as *Lan Jen Chu*, it will be clear to the inventor and his corporation that the invention will be patented. Given such an invention, the distinction between the patent application before and after an informal notice of allowability or a formal notice of allowance seems to be more a distinction of time than of substance, and therefore not a determinant of underlying value.⁵⁴ In *Lan Jen Chu*, for instance, the concurring opinion noted that “[t]he contract provided for royalty payments over time whether or not a patent was granted. The grant of a patent would not increase the size of the royalties, nor would its refusal reduce them.”⁵⁵ Thus, a transferor taxpayer might easily avoid the barrier imposed in *Stahl* by contracting with his controlled corporation prior to receiving any notice from the Patent Office, or perhaps even prior to filing his application for patent.

C. Legislative Solution

A legislative solution would offer a more direct and effective alternative. Congress could amend section 1239 to explicitly include within its scope sales and exchanges of patent rights prior to patent issuance. For example, patent applications could be provided for by adding the following language: “For purposes of this section, the sale or exchange of all substantial rights to a patent, if represented by a patent application or otherwise, shall be deemed the sale or exchange of property of a character which is subject to the allowance for depreciation provided in section 167.” The purpose served by using the words “all substantial rights to a patent, if represented by a patent application or otherwise” is to preclude attempts to evade the section by transferring rights prior to the filing of an application. The suggested language would require that a sale or exchange of patent rights at any time prior to patent issuance, as well as during the life of the patent, be included within the restrictions of section 1239(a).

Such a provision might be considered overly inclusive. Perhaps it would be desirable to exclude transfers of patent rights where patentability is truly speculative.⁵⁶ A mechanism would be re-

⁵⁴ See note 18 *supra*.

⁵⁵ 486 F.2d at 705 (concurring opinion).

⁵⁶ At some point prior to patent issuance, while the patent application is pending or prior to application for patent, it might be considered that eventual patent issuance is so speculative that § 1239's purpose of preventing the joint benefits of capital gains treatment and depreciation allowance in certain transactions would not be furthered enough to warrant the potential unfairness to a transferor, should his invention in fact not be patented.

quired, therefore, to distinguish sales and exchanges according to the likelihood of patentability. In the *Stahl* case this distinction depended upon receipt of notice from the Patent Office indicating patentability. Other ways of distinguishing might best be left to IRS regulations.

Variations in statutory language would permit flexibility by administrative regulation. The language suggested above for amending section 1239 could be altered as indicated below by the italicized words to allow such flexibility: "For purposes of this section, the sale or exchange of all substantial rights to a patent, if represented by a patent application or otherwise, shall be *presumed to be* the sale or exchange of 'property of a character which is subject to the allowance for depreciation provided in section 167.' *This presumption shall be subject to such regulations as the Secretary or his delegate may prescribe.*" Because the subsection provides only for a presumption of depreciability, the way would be open for a transferor to prove otherwise in an appropriate case. The Commissioner could also limit by administrative regulation the inclusiveness of the presumption in order to exclude those situations in which patentability is considered so remote and speculative that the property's future depreciability is truly unpredictable.

D. *Administrative Solution*

Even under the present statutory language, administrative regulation could provide a solution. The phrase "of a character . . . subject to . . . depreciation" is probably broad enough to permit a treasury regulation to the effect that, for purposes of section 1239, patent applications will be treated as depreciable property.⁵⁷ This regulation would seem to reflect the expectations of the parties to a

⁵⁷ Such a regulation would resemble the regulation upheld in *Bingler v. Johnson*, 394 U.S. 741 (1969) (see note 49 *supra*). In *Bingler* the contested regulation defined the statutory term "scholarship." With regard to § 1239, the proposed regulation would define "of a character . . . subject to . . . depreciation." In *Bingler* the court of appeals had relied on an inconclusive statutory history and the canon of construction that *expressio unius est exclusio alterius* in holding the regulation invalid. The Supreme Court responded that

[s]ection 117 provides, however, only that amounts received as "scholarships" or "fellowships" shall be excludable [from income]. And Congress never defined what it meant by the quoted terms. . . . The regulation here in question represents an effort by the Commissioner to supply the definitions that Congress omitted. And it is fundamental, of course, that as "contemporaneous constructions by those charged with administration of" the Code, the Regulations "must be sustained unless unreasonable and plainly inconsistent with the .revenue statutes," and "should not be overruled except for weighty reasons."

Bingler v. Johnson, 394 U.S. 741, 749-50, quoting *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948) (footnote omitted).

patent application transfer that eventually a patent will issue.⁵⁸ Judge Campbell of the First Circuit suggested that a regulation embodying similar provisions would be acceptable.⁵⁹

It is conceivable, of course, that a fear expressed in the *Lan Jen Chu* opinion might be realized if such a regulation were promulgated or if one of the proposed amendments to the section were enacted. The court of appeals was concerned that

the inventor who has the misfortune to transfer a patent application that is subsequently disapproved would face the worst of both possible worlds: he would pay ordinary income rates on his initial gain from the transfer, while his controlled corporation would never be able to take any depreciation deduction against ordinary income.⁶⁰

The harshness feared by the court is ameliorated, however, by section 1239's allowance of a substantial tax advantage to the transferor even where he owns up to eighty percent of the transferee corporation. In addition, explicit statutory provisions or administrative regulations would put all prospective transferors and transferees on notice of possible disadvantageous tax consequences.

Despite the concern shown by the *Lan Jen Chu* court, the degree of risk involved in such transfers is probably minimal. Patent rights are saleable prior to patent issuance, it may be assumed, largely because the parties can predict patentability. If the particular facts of the transfer are such that the parties see no risk, or small risk, of non-patentability, then there is a correspondingly minor risk that the transferor "would face the worst of both possible worlds." Besides, an inventor or other holder of patent rights desiring absolute certainty before transferring to his controlled corporation can achieve that certainty simply by waiting until a patent is issued—or finally denied. By so doing, he will know definitely whether a depreciation allowance is available to the transferee and he will not fall prey to losing both his capital gain advantage and his corporation's depreciation allowance.

By taking such a cautious course, the inventor and entrepreneur would lose the effective extension of the patent

⁵⁸ See note 18 *supra*.

For the reasons offered in discussing an amendment to § 1239 of the Code, the proposed regulation should afford the taxpayer the opportunity to prove that a patent will not issue in the normal course. See text accompanying note 56 *supra*.

⁵⁹ *Lan Jen Chu v. Commissioner*, 486 F.2d 696, 705 (1st Cir. 1973) (concurring opinion).

⁶⁰ *Id.* at 701.

monopoly—usually a matter of several years—that results from initiating operations under the patent while the application is still pending. However, this pre-patent monopoly is simply a windfall, and neither Congress nor the IRS should consider this possible loss a sufficient reason for hesitation in eliminating a tax loophole.

IV

CLOSING THE BREACH—SECTION 1235

While section 1239 of the Code, the central statute in *Lan Jen Chu*, limits capital gains treatment of the proceeds from sales or exchanges of depreciable property between certain related persons, the underlying availability of capital gains treatment derives from other sections of the Code. These provisions give rise to alternative methods for plugging the section 1239 loophole.

The transferor of patent rights may look to three Code sections for capital gains treatment. Two of these, sections 1221⁶¹ and 1231,⁶² are of general applicability and, for purposes of this discus-

⁶¹ § 1221. Capital asset defined.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

INT. REV. CODE OF 1954, § 1221.

⁶² Under § 1231 of the Code net gain from the sale, exchange, or involuntary conversion of depreciable business property held for more than six months which is neither inventory, primarily for sale to customers, nor a copyright, literary, musical or artistic

sion, can be treated alike. Taking capital gains under sections 1221 and 1231 will be referred to as the "ordinary" method. The third Code provision, section 1235,⁶³ the "special" method, is directed exclusively to the sale or exchange of patents and patent rights.

Chu presumably relied upon the "ordinary" method in declaring the proceeds from sale of his patent application as long-term capital gain. Accordingly, he had to satisfy three conditions: (1) the patent application must be a "capital asset" in the transferor's hands;⁶⁴ (2) the transfer must be a "sale or exchange";⁶⁵ and (3)

composition in the hands of certain taxpayers, is treated as long-term capital gain while net loss is treated as ordinary loss.

Originally enacted as § 117(j)(2) of the 1939 Code, § 1231 was reenacted substantially unchanged in the 1954 Code. H.R. REP. No. 1337, 83d Cong., 2d Sess. A275 (1954).

⁶³ § 1235. Sale or exchange of patents.

(a) General.

A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(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.

(b) "Holder" defined.

For purposes of this section, the term "holder" means—

(1) any individual whose efforts created such property; or

(2) 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 covered by the patent, if such individual is neither—

(A) the employer of such creator, nor

(B) related to such creator (within the meaning of subsection (d)).

(c) Effective date.

This section shall be applicable with regard to any amounts received, or payments made, pursuant to a transfer described in subsection (a) in any taxable year to which this subtitle applies, regardless of the taxable year in which such transfer occurred.

(d) Related persons.

Subsection (a) shall not apply to any transfer, directly or indirectly, between persons specified within any one of the paragraphs of section 267(b); except that, in applying section 267(b) and (c) for purposes of this section—

(1) the phrase "25 percent or more" shall be substituted for the phrase "more than 50 percent" each place it appears in section 267(b), and

(2) paragraph (4) of section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants.

INT. REV. CODE OF 1954, § 1235(a)-(d).

⁶⁴ INT. REV. CODE OF 1954, §§ 1221, 1222(3).

If Chu's patent had been "property used in the trade or business" (§ 1231(a)) it would have qualified for capital gains, if at all, under § 1231. See General Spring Corp., 22 P-H TAX CT. REP. & MEM. DEC. 770, 776 (1953). Because the "sale or exchange" and holding period requirements are identical for capital assets and "§ 1231 assets," the textual discussion applies equally to both.

⁶⁵ INT. REV. CODE OF 1954, §§ 1222(1)-(10), 1231(a).

the patent application must have been held longer than six months.⁶⁶

The problems which confronted inventors prior to the enactment of section 1235 stemmed from the first two requirements. In determining whether a patent is a "capital asset" the traditional dividing line has been drawn between amateur and professional inventors, a distinction which has given rise to arbitrary results in practice.⁶⁷ If the taxpayer is found to be an amateur inventor, his patent may qualify as a capital asset, while a patent developed by a professional inventor is necessarily excluded from capital asset status because it is "property held . . . primarily for sale to customers in the ordinary course of . . . business."⁶⁸

The traditional test for determining whether a "sale or exchange" of patent rights has occurred depends on whether the transfer is an assignment or a license.⁶⁹ In general, the transaction is characterized as an assignment where the transferor gives to the transferee "all substantial rights" under the patent.⁷⁰ But where

⁶⁶ *Id.* §§ 1222(3), 1231(a).

⁶⁷ See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 82 (1954). Compare *First National Bank v. United States*, 136 F. Supp. 818 (D.N.J. 1955) (although inventor in business of making and selling optical and acoustical inventions, held amateur inventor of mechanical tooth-brush bristle grinder), with *Harold T. Avery*, 47 B.T.A. 538 (1942) (patent sold in "ordinary course of trade or business" when, out of twelve patents developed over seventeen years, inventor sold three patents and granted rights in two others).

⁶⁸ INT. REV. CODE OF 1954, § 1221(1).

⁶⁹ See, e.g., *Broderick v. Neale*, 201 F.2d 621 (10th Cir. 1953); *Lamar v. Granger*, 99 F. Supp. 17, 36 (W.D. Pa. 1951); R. ELLIS, PATENT ASSIGNMENTS §§ 49, 55 (3d ed. 1955); Dunn, *Tax Considerations in Patent Assignments and Licenses Between Related Corporations*, 16 TAX L. REV. 315 (1961); Note, *Capital Gains Treatment of Patent Transfers*, 17 CASE W. RES. L. REV. 844, 859 (1966).

⁷⁰ In a patent infringement case, *Waterman v. Mackenzie*, 138 U.S. 252 (1891), a test for distinguishing patent assignments from licenses was introduced which was used extensively in tax cases in subsequent years. The Court said that an assignment can be nothing less than

the exclusive right to make, use and vend the invention throughout the United States; or . . . an undivided part or share of that exclusive right; or . . . the exclusive right under the patent within and throughout a specified part of the United States. . . . Any assignment or transfer, short of one of these, is a mere license . . .

Id. at 255. The terminology "make, use and vend," of course, describes precisely the monopoly given the patentee. See note 14 *supra*.

Section 1235 of the Code refers to "[a] transfer . . . of all substantial rights to a patent, or an undivided interest therein." The Senate report evidences the intent to include, by these words, the criteria for a sale or exchange which had been developed in the case law. See S. REP. NO. 1622, 83d Cong., 2d Sess. 113-14 (1954).

Thus, the issue now is examined by the IRS and the courts in terms of whether or not "all substantial rights" have been transferred regardless of the Code section under which the transfer is viewed. But the underlying test remains the same as that enunciated in *Waterman*. See Treas. Reg. § 1.1235-2(b)(1), T.D. 6263, 1957-2 CUM. BULL. 572; Porter, *Capital Gains on Patents Without Benefit of Section 1235*, 41 TAXES 800, 801 (1963).

any substantial right is withheld, the transaction is characterized as a license.⁷¹

Related to the question of whether "all substantial rights" are transferred is the method adopted for payment. It is common for the purchase price to vary with the patent's use or productivity. This method of payment was used in *Lan Jen Chu* where a large portion of the consideration was represented by a promise to pay to the transferor fifteen percent of the gross selling price of every antenna system manufactured and sold by the purchasing corporation.⁷² It was long argued by the IRS that such contingency payments are royalties, and because the transferor retained a right to royalties, considered by the IRS to be a substantial right in the patent, the transaction was to be regarded as a license so that capital gains treatment was unavailable to the transferor.⁷³

It was against this background, in which "professional" inventors were ineligible for capital gains treatment and "amateurs" faced the prospect of litigation where the proceeds from the patent transfer were contingent on productivity or use, that section 1235 was enacted by Congress. The new provision was intended to "liberalize the tax treatment of income from inventions in order to remove barriers which thwart and discourage the genius of the independent American inventor,"⁷⁴ and "to provide a larger incentive to all inventors to contribute to the welfare of the nation."⁷⁵ Section 1235 was intended to promote individual inventiveness⁷⁶

The question of what rights can be retained by the patent transferor while still fulfilling the "all substantial rights" test has perplexed a great many taxpayers, IRS personnel, and courts. The basic rule that "all substantial rights" means the exclusive right to "make, use and vend" is subject to numerous qualifications. See, e.g., *Rollman v. Commissioner*, 244 F.2d 634 (4th Cir. 1957) (transfer of patent where vendee agreed not to assign right to use except in conjunction with transfer of all vendee's business held assignment); *Armco Steel Corp. v. United States*, 263 F. Supp. 749 (S.D. Ohio 1966) (exclusive rights to manufacture and sell in one country held assignment); *Gruber v. United States*, 158 F. Supp. 510 (D. Ore. 1958), *rev'd on other grounds sub nom.*, *Mayer v. United States*, 285 F.2d 683 (9th Cir. 1960) (licensing agreement held sale although right to use omitted from transfer where right to use of no commercial value); *Estate of Milton P. Laurent, Sr.*, 34 T.C. 385 (1960) (assignment of undivided part of all patent rights held sale); 3B J. MERTENS, *supra* note 34, § 22.133, at 922; Breier, *Special Provision for Inventors Insures Capital Gains but Requires Strict Compliance*, 7 TAXATION FOR ACCOUNTANTS 226, 229 (1971); Dunn, *supra* note 69; Porter, *supra* at 800, 802; Note, *supra* note 69, at 845-46; Comment, *Capital Gains Treatment on Proceeds from Patent Transfers*, 34 Mo. L. Rev. 98, 105 (1969); P-H 1974 FED. TAXES ¶ 32,408.

⁷¹ See, e.g., *Waterman v. Mackenzie*, 138 U.S. 252, 255 (1891).

⁷² See note 18 and accompanying text *supra*.

⁷³ See Mim. 6490, 1950-1 CUM. BULL. 9.

⁷⁴ 100 CONG. REC. 8996 (1954) (remarks of Senator Millikin).

⁷⁵ H.R. REP. NO. 1337, 83d Cong., 2d Sess. A280 (1954).

⁷⁶ See S. REP. NO. 1622, 83d Cong., 2d Sess. 113-14 (1954).

by treating sales or exchanges of patent rights by "holders"⁷⁷ as if they were sales or exchanges of capital assets held for more than six months, without regard to the actual holding period, without regard to royalty-like payments contingent upon the use or productivity of the patent, and without regard to whether the taxpayer is an amateur or professional inventor.⁷⁸ The section is inapplicable, however, to transactions between certain related persons, including transactions between an individual and a corporation twenty-five percent or more of which is owned by him.⁷⁹

A. *Section 1235 "Exclusivity"*

It is arguable that for transfers of patent rights where the transferor is a "holder" and the method of payment is described by section 1235(a)(1) or (2), as in *Lan Jen Chu*, this section supplies the exclusive means of capital gains treatment.⁸⁰ If this exclusivity had been accepted by the *Lan Jen Chu* court the action very likely would have been decided in favor of the IRS since the transferor clearly held a larger than twenty-five percent interest in the corporation.⁸¹ But the IRS made no such argument, apparently because it had previously decided that even where the transfer is by a "holder," and payment is by one of the methods prescribed by sections 1235(a)(1) and (2), section 1235 is not the exclusive path to capital gains.⁸²

After passage of section 1235, the IRS reversed its position regarding royalty payments and capital gains under the "ordinary" method. The new position of the IRS was stated in an acquiescence to *Edward C. Myers*⁸³ declaring that regardless of royalty-like pay-

⁷⁷ A "holder" is loosely defined as the inventor or his financier. See INT. REV. CODE OF 1954, § 1235(b).

⁷⁸ *Id.* § 1235.

⁷⁹ *Id.* § 1235(d)(1).

⁸⁰ See Myron C. Poole, 46 T.C. 392 (1966). See also Breier, *supra* note 70, at 231; Comment, *supra* note 70, at 102.

⁸¹ See *Lan Jen Chu v. Commissioner*, 486 F.2d 696, 699-700 nn. 2 & 3. (1st Cir. 1973).

⁸² Treas. Reg. § 1.1235-1(b) (1957); Rev. Rul. 69-482, 1969-2 CUM. BULL. 164.

⁸³ Rev. Rul. 58-353, 1958-2 CUM. BULL. 408. In *Edward C. Myers*, 6 T.C. 258 (1946), the inventor had transferred to B.F. Goodrich the exclusive "license" to make, use, and sell throughout the United States products under the inventor's patent for rubber-covered flexible steel track in return for annual payments based upon a percentage of total sales. Myers initially reported his royalties as ordinary income but later filed for a refund claiming that since the payments were received from the sale of a patent the gains should be taxable at capital gains rates. *Id.* at 261. The Commissioner argued that because the method of payment was inconsistent with a sale, the proceeds should be taxable as ordinary income. The Tax Court declined to view the method of payment as dispositive, preferring instead the test of what constitutes an assignment of patent rights laid down by the Supreme Court in *Waterman v. Mackenzie*, 138 U.S. 252 (1891). For the rule in *Waterman* see note 70 *supra*.

ments there is an assignment of patent rights where there is a grant of the exclusive right to make, use, and sell under the patent. Thus, if a transfer of patent rights otherwise qualified for capital gains treatment under the "ordinary" method, the fact that the proceeds were contingent upon productivity or use would be considered irrelevant to the availability of such treatment.

With the Commissioner's acquiescence in *Myers*, the way was cleared for the patent transferor to enjoy long-term capital gains tax rates on royalty-like proceeds under both the "ordinary" and "special" methods.⁸⁴ The ability to move between these two provisions gives the taxpayer a substantial advantage. Section 1235 does away with conditions the inventor may find onerous under the "ordinary" method, but restricts corporate relatedness more than section 1239. Corporate ownership is limited in the "ordinary" method only by section 1239(a)(2), which, in allowing the transferor or transferee to own as much as eighty percent of the corporate transferee or transferor, is considerably more generous than section 1235(d)(1), which limits this ownership to less than twenty-five percent.

These inconsistent limitations on relatedness have inspired controversy over whether section 1235, if applicable to a specific patent transfer, is intended to be the exclusive provision under which that transfer can qualify for capital gains treatment.⁸⁵ The IRS has announced, in Treasury Regulation section 1.1235-1(b) and Revenue Ruling 69-482,⁸⁶ that "the mere fact that a patent

Initially, the IRS had acquiesced in the *Myers* holding (1946-1 CUM. BULL. 3), but in 1950 the IRS reversed its position and issued a non-acquiescence (Mim. 6490, 1950-1 CUM. BULL. 9). See note 73 and accompanying text *supra*. After enactment of § 1235 the IRS again acquiesced in *Myers* (Rev. Rul. 58-353, 1958-2 CUM. BULL. 408), and this is its present position.

The Commissioner withdrew his 1946 acquiescence contemporaneously with the rise of sentiment in Congress that transfers of patents should be taxed at ordinary rates. In 1950, Congress amended the Internal Revenue Code of 1939 to exclude a "copyright, a literary, musical, or artistic composition, or similar property" held by the creator, or by one whose basis in the property was determined by reference to the creator's basis, from the capital gain sections. INT. REV. CODE OF 1939, §§ 117(a)(1)(c), (j)(1)(c) (INT. REV. CODE OF 1954, §§ 1221(3), 1231(b)(1)(c)). The House bill excluded patents held by inventors as well, but this provision was deleted in the Act because it was considered desirable to foster individual inventiveness through tax incentives. See S. REP. NO. 2375, 81st Cong., 2d Sess. 44 (1950).

⁸⁴ It would be incorrect on the basis of the IRS acquiescence in *Myers* to conclude that § 1235 is now surplusage. On the contrary, § 1235 offers the inventor several liberal provisions: the section disregards the professional/amateur distinction, there is no required holding period, and there is assurance that royalty payments will not be treated as ordinary income.

⁸⁵ See, e.g., Breier, *supra* note 70, at 231; Comment, *supra* note 70, at 102.

⁸⁶ Rev. Rul. 69-482, 1969-2 CUM. BULL. 164.

transfer by a holder for contingent amounts does not qualify for long-term capital gains treatment under section 1235 of the Code, will not prevent it from qualifying for such treatment under other provisions of the Code"⁸⁷ The Tax Court, on the other hand, held in *Myron C. Poole*⁸⁸ that

if the payments for a patent are contingent upon productivity, use, or disposition, or if they are payable periodically over a period generally coterminous with the transferee's use of the patent, section 1235 is the holder's exclusive provision for qualifying for capital gains treatment.⁸⁹

The statutory language provides no solution to these different interpretations. Equal support for both positions can be found in the legislative history of section 1235. The Senate Committee Report on the bill, for example, stated:

In enacting this section . . . your committee has no intention of affecting the operation of existing law in those areas *without its scope*. For example, the tax consequences of the sale of patents . . . by individuals who fail to qualify as "holders," or by corporations, is to be governed by the provisions of existing law as if this section had not been enacted.⁹⁰

The IRS invoked this passage in Revenue Ruling 69-482⁹¹ to support its decision that section 1235 was not exclusive. The passage is ambiguous, however, since it fails to define what is meant by "areas without its scope." It is unclear whether failure of *any* one requirement embodied in section 1235—*e.g.*, a sale between an individual and a corporation twenty-five percent or more of which is owned by him—puts the transfer outside that section's scope, or whether only a failure of the "holder" requirement found

⁸⁷ *Id.*

⁸⁸ 46 T.C. 392 (1966).

⁸⁹ *Id.* at 404.

⁹⁰ S. REP. NO. 1622, 83d Cong., 2d Sess. 441 (1954) (emphasis added).

In the same paragraph of its Report the Senate Finance Committee stated:

It is the intention of your committee that, if the mode of payment is as described in subsection (a), the sale of a patent by any "holder" must qualify under the section in order for such "holder" to obtain capital gain treatment. However, the benefits of this section are to be limited to those individuals and transfers qualifying under its terms.

Id.

It was said in the House Report, however, that

This section provides the only method under the new code whereby the inventor of a patent can obtain capital gains on its sale. Failure on the part of the seller to meet its conditions will result . . . in the entire transaction being taxed to him as resulting in ordinary income.

H.R. REP. NO. 1337, 83d Cong., 2d Sess. A280 (1954).

⁹¹ 1969-2 CUM. BULL. 164.

in subsection (b) puts the transfer outside its scope. Use of the words “[f]or example” lends credence to the former view. Nevertheless, the Tax Court adopted the latter position in *Myron C. Poole*,⁹² relying upon an ostensibly logical interpretation of the section:

If a holder transfers a patent resulting in the payment of royalties in the manner described in section 1235(a) to a related person, and if we were to hold that such a transfer is entitled to capital gains treatment under another provision of law, we would be nullifying section 1235(d).⁹³

The court’s objection might be answered, however, by reference to the fact that Congress, during discussion of section 1235, was aware of court rulings in favor of the applicability of capital gains treatment even though the patent seller’s proceeds were in the form of royalty-like payments,⁹⁴ yet it failed to revoke such applicability explicitly. Furthermore, Congress knew that the IRS position was not dispositive of the issue, but only created uncertainty.⁹⁵ It can be argued that section 1235, rather than being an attempt to preempt the question, was intended only “[t]o obviate the uncertainty” by giving “statutory assurance”⁹⁶ to certain holders and within certain limits (*e.g.*, section 1235(d)(1)). Beyond these limits, section 1235 arguably was intended to have no effect.⁹⁷ The “statutory assurance,” it might be argued, was given only to the degree necessary to afford a secure “opportunity [for] inventors to dispose of their patents,”⁹⁸ and beyond this a “holder” might still have a capital gain if his particular circumstances fit the narrower qualifications imposed by the “ordinary” method.⁹⁹

⁹² 46 T.C. 392 (1966).

⁹³ *Id.* at 404.

⁹⁴ S. REP. NO. 1622, 83d Cong., 2d Sess. 439 (1954).

⁹⁵ According to the Senate Report, “the prospect of continued litigation was engendered in this area by the issuance of Mimeograph 6490 . . .,” therefore, section 1235 was intended “[t]o obviate the uncertainty caused by this mimeograph.”*Id.*

⁹⁶ *Id.*

⁹⁷ *See, e.g., id.* at 441:

The sale of a patent between an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, . . . by or for such individual would not, for example, be entitled to capital gain treatment *under this section*.

(emphasis added). Section 1235(d), as originally enacted, adopted the limits of § 267(b) and denied capital gain treatment where the transfer was between an individual and a corporation in which he owned “more than 50 percent” in value of the stock. Section 1235(d) was amended in 1958 to lower the permissible ownership value to “25 percent or more.” Technical Amendments Act of 1958, Pub. L. No. 85-866, § 54(a), 72 Stat. 1644.

⁹⁸ H.R. REP. NO. 1337, 83d Cong., 2d Sess. A280 (1954).

⁹⁹ It can also be argued that construing § 1235 as an exclusive path to capital gains on holders’ sales of patents contradicts the section’s liberalizing purpose. The argument results

This discussion is not intended to suggest, however, that the Tax Court's holding in *Poole* is not substantially supported by reference to the section's legislative history. On the contrary, several passages in both the House and Senate reports strongly suggest that it was indeed believed that section 1235 would provide the only method of obtaining capital gains treatment for patent holders to whom proceeds were payable periodically or contingent on the patent's use or productivity.¹⁰⁰ Since the statutory language itself contains no words of exclusivity and because the legislative history provides only contradictory answers to the question, a final answer may have to await congressional clarification.

B. Section 1235 Exclusivity as a Solution

Because the applicability of section 1235, unlike that of section 1239, is not dependent upon the depreciable character of the transferred property, it might be concluded that the *Lan Jen Chu* problem could be solved by the exclusive application of section 1235 as in *Poole*.¹⁰¹ Thus, a transferor of a patent application, such as Chu, would not be eligible to take his consideration as capital gain because he owns "twenty-five percent or more" of the transferee's capital stock. Because applicability of section 1235, unlike section 1239, does not depend upon depreciability, the theory continues, the loophole in sales of patent applications among related parties would be closed. Because Chu apparently was a "holder," the decision in that case probably would have been favorable to the IRS had section 1235 been the exclusive capital gains provision for patent transfers by holders. Even if section 1235 were so construed, however, the larger problem presented in

from the fact that at least certain inventors could realize capital gains on royalty-like proceeds from sales of patents prior to enactment of § 1235 (see Edward C. Myers, 6 T.C. 258 (1946)). Since the restriction on capital gains among related persons (§ 1239(a)(2)) under the "ordinary method" (see notes 61 & 62 and accompanying text *supra*) at the time of enactment of § 1235 was more liberal than under the "special method" (see note 63 and accompanying text *supra*), enactment of § 1235 as an exclusive method of capital gains would have the actual effect, in this respect, of taking away a tax incentive. It should be noted, however, that this argument is somewhat less forceful when looking back at the time of § 1235's enactment when the limit on relatedness in a transfer between a corporation and shareholder was not as far from the "more than 80 percent" of § 1239(a)(2). Originally, capital gains were allowed under § 1235 except in transactions among related persons as defined by § 267(b). The latter section provided for corporate interests as high as 50 percent. Section 1235(d) was amended by the Technical Amendments Act of 1958, Pub. L. No. 85-866, § 54(a), 72 Stat. 1644, which lowered the permissible interest limit to its present "25 percent or more." INT. REV. CODE OF 1954, § 1235(d)(1).

¹⁰⁰ See note 90 *supra*.

¹⁰¹ 46 T.C. 392 (1966).

the *Lan Jen Chu* case would nevertheless remain untouched, for a non-“holder” transferor of a patent application—*e.g.*, the inventor’s transferee—would fall outside the scope of section 1235. Thus, section 1239’s inapplicability to non-depreciable patent applications would still leave a loophole for non-“holders.”

In order for section 1235 to solve the problem resulting from the non-applicability of section 1239 to patent application transfers, they would have to be brought within the enlarged scope of an amended section 1235(d). The heart of section 1235, embodied in section 1235(a), would remain unaltered. Only the restrictive part of the section, subsection (d), would be enlarged so as to apply not only to section 1235 transfers, but to all transfers of patent rights not limited by section 1239. The availability of capital gains treatment on transfers of patent rights would therefore be limited by a restriction on the relation of transferor to transferee under either section 1235 or section 1239 regardless of the form of the rights or the statutory methods under which capital gains treatment was sought. Thus, related transferees of issued patents would be restricted by either section 1235(d) or 1239(a) depending upon whether the transferor claimed capital gains under section 1235 or under section 1222; transferees of patent applications would be restricted in both instances by section 1235(d).

As a final step in this alternative solution restrictions on relationships among the parties to the transaction which would deny capital gains treatment to the patent application transferor under section 1235(d) should be made equivalent to the counterpart restrictions under section 1239(a). Although varying policy considerations may account for the difference in the disqualifying corporate interests embodied in these two sections, those policy considerations would be inapplicable in differentiating patent applications from issued patents. Since the purpose of amending section 1235(d) is to equalize the statutory treatment applied to patents and applications, meaningless ancillary differences in statutory treatment are undesirable.

CONCLUSION

Section 1239 of the Code is intended to restrict the availability of capital gains on transfers of depreciable property among related taxpayers. While patent applications are not depreciable, their transfer among related parties gives rise to abuses otherwise foreclosed by section 1239. No substantial distinction meaningful for

income tax purposes exists between transfers of patent applications and transfers of patents. Therefore, the tax law should apply equally to both.

Judicial, administrative, and statutory solutions are available to close the section 1239 loophole delineated in *Lan Jen Chu*. The judicial solution employed in *Stahl* has the advantage of immediate availability; but it is too easily avoided. A treasury regulation would be the quickest solution and would be effective to close the loophole by providing that patent applications will be considered "of a character" subject to depreciation. Finally, Congress might either amend section 1239(b) to include patent applications, or enlarge section 1235 so that all transfers of patent rights would be included within the proscriptions of section 1235(d).

Leslie D. Locke