The Tax Consequences of the Sale of a Patent

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methods at radically different results, where their difference in purpose is not sufficient to explain or justify the disparity.

It would seem desirable that if a mechanism must have two pendulums, at least they should operate in phase.

Walter J. Barrett

THE TAX CONSEQUENCES OF THE SALE OF A PATENT

The tax treatment to be accorded the transfer of patents is an area in the field of federal income taxation which has given rise to perplexing problems and persistent litigation. As is the case in any transfer of assets today, the transferor of rights to a patent naturally seeks to avail himself of capital gain benefits. However, in any situation other than the ideal, the transferor of a patent now has many intricate and uncertain problems facing him. The source of much of this difficulty is first, the limited scope of the present statutory scheme which requires those outside its narrow, complicated mandate to seek relief under the law evolved prior to its enactment, and second, because in applying this latter law, one must contend with a questionable ruling of the Commissioner which is contrary both to expressed legislative policy and to the economic realities surrounding the transfer of a patent. The first phase of this comment shall consist of a discussion of the law as it developed prior to the 1954 Code and the second phase shall discuss the 1954 Code in light of recently adopted regulations.

THE LAW PRIOR TO THE 1954 CODE

Prior to the enactment of the 1954 Code, the taxpayer had several serious hurdles to overcome before he could obtain capital gain benefits: (1) Was the patent a capital asset, or a section 117(j) asset, held for more than six months? (2) Was there a sale or exchange? (3) Would the contention of the Commissioner with respect to the mode of payment defeat the sale?

Was the patent a capital asset held for more than six months?

Prior to 1942, in order for a patent to be treated as a capital asset, it could not be depreciable property used in the taxpayer's trade or business, stock in trade or inventorial property, or property held primarily for sale to customers in the ordinary course of the taxpayer's business. In other words, the taxpayer had to show that he was not a professional inventor or, if an investor, that he was not a dealer in inventions. An analysis of the cases deciding this factual question

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indicates a certain liberality in finding an amateur status provided the inventor was clearly not in the business of making and marketing inventions. For example, the presence of the following circumstances did not affect the taxpayer’s amateur standing: the intermittent and irregular nature of inventive activities;² prior transactions with a business in which the taxpayer had a proprietary interest;³ a single sale notwithstanding other activity such as obtaining patents or giving licenses;⁴ and finally even the fact that the inventor was a professional in one field did not affect the sale of an invention in another.⁵

Subsequent to 1942, it is at least arguable that although the taxpayer might be in the business of inventing, i.e., the patent was depreciable property used in his trade or business, he still could achieve capital gain benefits if he was not in the business of marketing such inventions to customers and they did not constitute inventorial property.⁶ By virtue of section 117(j),⁷ the property could be considered a “quasi-capital” asset.

Although the patent was deemed a capital, or quasi-capital asset, the taxpayer still had to meet the six month holding period requirement. There is no doubt that the earliest point from which the holding period could be computed was the date of “actual reduction to practice.”⁸ However the determination of when the patent was actually reduced to practice was far from elemental. At first the cases and the Treasury took the position that actual reduction to practice occurred when the first successful test was completed.⁹ Subsequent cases have held that completed drawings or notes sufficient to make manufacture possible would be denominated actual reduction to practice.¹⁰ The final note of confusion was added in 1957 when the Commissioner, in his regulations promulgated under section 1235 of the 1954 Code, announced that actual reduction to practice might occur before or after application for a patent "but cannot occur later than the earliest time that commercial exploitation of the invention occurs."¹¹

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3. Harold F. Silver, supra note 2; Kronner v. United States, 110 F. Supp. 730 (Ct. Cl. 1953); cf. Harold T. Avery, 47 B.T.A. 538 (1942); Leo M. Harvey, supra note 2.
6. Margaret F. Lockhart, supra note 2; Lester P. Barlow, 2 T.C.M. 133 (1943).
9. Lester P. Barlow, supra note 6; see note 8 supra.
10. Edward C. Myers, 6 T.C. 253 (1946); Arthur C. Cope, 12 T.C.M. 525.
Having determined that the patent was a capital, or quasi-capital asset held for more than six months, it remained for the taxpayer to fulfill the sale or exchange requirement.

Was there a sale or exchange of all substantial rights to the patent?

In order to qualify a transaction as a sale or exchange, the taxpayer had to transfer all substantial rights to the property. Thus the problem was what constituted a transfer of all substantial rights to a patent, or, put another way, what rights could the transferor retain without the transaction being deemed inconsistent with the passage of ownership.

An important guide to the solution of this question was the case of Waterman v. Mackenzie. There, in a patent infringement setting and concerning the right of a transferee of a patent to maintain such an action, the Court discussed four significant points relevant to our problem: (1) that the form of the transaction was not controlling but rather its legal effect should be scrutinized; (2) that to constitute a sale, the transferor must convey exclusive rights to make, use and sell the invention; (3) that the exclusive right to make, use and sell might be limited to a specific geographical area; and (4) that an undivided interest in the invention could be conveyed.

The courts have had no trouble with the form v. substance distinction in certain areas, but when called upon to consider whether the exclusive right to make, use and sell has been transferred, some difficulty has been encountered. In three cases, for example, the omission, from the grant, of the right to use resulted in the transaction being termed a license. However most courts have taken the view that from other circumstances surrounding the transfer a right to use could be implied or, in other words, literal adherence to the Waterman doctrine was unnecessary. Thus the transfer of "all right, title and interest" would not preclude a sale.

In any event, it may be said that, regardless of form, what was necessary to give a transfer the legal indicia of a sale was the passage of ownership and, in the
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case of patents, ownership meant the exclusive right to make, use and sell or whatever words would indicate the intent to grant to the transferee the same monopolistic rights theretofore held by the transferor.

If inventors or investors were concerned only with transferring every right they had to a patent, without qualification or protection, the transaction could be carried out with comparative facility. But economic realities invariably complicated the matter.

Often the transferor desired to limit the rights granted to a specific geographical area. Since the Waterman doctrine permitted such a limitation, the courts have respected such provisions in an agreement, if exclusive rights to make, use and sell in that area were transferred. A complication arose however when a transaction limited the rights conveyed to a particular industry. In United States v. Carruthers the agreement restricted the grant to the tuna industry. The court reasoned that since a sale of patent rights could be limited to a specific area, there was no reason why it could not be limited to a specific industry. Realizing the presence of the requirement that all rights in an area must be granted, the court proceeded to discern that the invention in question had only speculative value in other than the tuna industry. Therefore it determined that all substantial rights in the patent had actually been transferred.

Certain problems were raised when the transferor retained a right to use the patent. At first glance such a retention would seem inconsonant with Waterman. However if the use was not competitive with the transferee's rights, it was not an unreasonable extension of Waterman to hold that the reservation was of an undivided interest in the patent rights, or was merely a license back by the transferee of a limited right to use. It is submitted that this view is correct only if the patent is capable of being clearly segregated into uses none of which will affect the monopoly of the transferee.

Recognizing not only the desire of the assignor and assignee to protect their interests, but also the risks involved in a sale of a patent, the courts have generally allowed a limited retention of rights in the form of security interests or conditions subsequent. Thus it has been held that the assignor may terminate the agreement if the assignee defaults in payments becomes bankrupt, fails

18. 219 F.2d (9th Cir. 1955).
to use his best efforts to market the invention, or fails to make and sell a specified amount. In addition the assignor has been permitted to retain rights to sue for infringement although this is questionable if the payments are not deemed part of the purchase price, to restrict sub-licensing or reassignment unless the assignee transferred the entire business, or to prohibit sub-licensing without the consent of the assignor. On the other hand the transferee could terminate in the event the invention proved to be worthless.

Although the taxpayer may have been able to surmount the aforementioned difficulties, there remained, after 1950, one problem which seemed for all practical purposes to preclude the accrual of capital gain benefits.

The Commissioner's position with respect to the mode of payment.

Until 1950 it was well established that if a transfer met the requirements of the Waterman test, it would be viewed as an assignment giving rise to capital gain treatment regardless of the mode of payment.

However in 1950, the Commissioner, by way of a ruling reciting his non-acquiescence in the Myers case, took the position that, after June 1, 1950, where the purchase price was cast in the form of payments contingent upon a fixed percentage of the selling price of the fruits of the invention, or contingent upon the number of units sold, or any other method based on production, use or sale, or periodic over a period coterminous with the use of the patent, the payments were to be considered royalties and taxable as ordinary income.

Until this ruling, no serious question had been raised regarding the mode of payment pursuant to an otherwise valid sale. This is explainable in part from the fact that prior to 1950 the revenue laws did not expressly provide for the tax treatment of patents, copyrights and other similar property. The requirements, as hereinbefore mentioned, were that the property be a capital asset and that there be a sale or exchange of such asset. If these tests were met, the mode of payment

29. Lawrence v. United States, supra note 15; Monie S. Hudson, supra note 22. See also Kronner v. United States, supra note 13.
would not limit or qualify the effect of the grant. However the Revenue Act of 1950 as originally passed by the House sought to prohibit capital gain benefits to those whose personal effort and services had created such properties as patents, copyrights, and similar property.\(^{32}\) As a presage of the special treatment to be subsequently accorded patents, the Senate Committee with significant language\(^{33}\) excluded patents from the operation of sections 117(a)(1)(C) and 117(j)(1)(C) [now sections 1221(3) and 1231(b)(1)(C)]. Thus a policy of fostering and giving incentive to the efforts of inventors was established. It was true that the only realistic way to purchase a patent was not a lump sum payment but rather to make the price contingent in some manner upon the ultimate value of the patented property. Such value in turn could be determined only by its commercial effectiveness. But this was true also of copyrights, and other similar property. The property involved, in either case, was the product of personal effort. One is hard pressed to find any basis for diverse tax treatment, other than the above policy. Therefore from a strictly consistent tax viewpoint the Commissioner's position may be well taken.

In this anomalous setting the Commissioner announced his ruling with respect to contingent payments. If one presupposes the wisdom of granting incentive to inventors solely, then the ruling is incompatible with such policy, as well as with the legal and economic realities surrounding the transfer of a patent. If the transfer meets the established criteria to effect the passage of ownership then the mode of payment should not destroy the tax benefits ordinarily accompanying the sale of a capital asset. To so withdraw the benefits would seem clearly incongruous with the stated policy.

In any event, the Commissioner's ruling met with a notable lack of success. The Tax Court and other courts persistently rejected his contention.\(^{34}\) In fact the position gained support in only two cases, the first of which is of significance to New York practitioners. In *Bloch v. United States*,\(^ {35}\) a case dealing with the tax consequences of a transfer by a non-resident alien under section 211(a) of the 1939 Code, the court stated: "The many substantial rights in the patent retained by plaintiff are further indications of the failure to transfer absolute ownership for purposes of §211(a). But the crux of the matter seems to be the retention of an interest in the profitable exploitation of the patented articles by receipt of a

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33. "Your committee believes that the desirability of fostering the work of such (amateur) inventors outweighs the small amount of additional revenue which might be obtained under the House bill, and therefore the words 'invention,' 'patent,' and 'design' have been eliminated." S. Rep. No. 2375, 81st Cong., 2d Sess., U.S. Cong. & Ad. News 3097-98 (1950).
34. Carl G. Dreymann, 11 T.C. 153 (1948); Kronner v. United States, supra note 13; Vincent A. Marco, supra note 17; Arthur C. Ruge, supra note 21; Watson v. United States, supra note 13.
35. 200 F.2d 63 (2d Cir. 1952).
percentage of the sales price or a stated amount for each article sold." Furthermore
the court stated that the Waterman case was not necessarily authority in a tax
situation. The Bloch case has been distinguished often on the ground that it dealt
with a non-resident alien and a special section.\[36\] Such distinction appears valid
in view of the fact that the Bloch opinion itself distinguished a prior Second
Circuit case\[37\] in which it was held that such contingent payments to a resident
did not preclude capital gain treatment. The Bloch decision should be limited to
its facts, but the quoted language was nevertheless strong support for the Treasury's
contention.\[38\] The second case often cited by the Commissioner as lending support
to his position is Broderick v. Neale.\[39\] This case has also been distinguished many
times on the ground that the transferor did not convey the exclusive right to use
the invention and thus did not meet the Waterman test of a sale.\[40\] Therefore
citing Bloch was unnecessary.

However unsuccessful the Commissioner may have been, he persisted in his
position and this, coupled with the other problems surrounding a transfer, led to
constant litigation and perplexity. It was in this situation of general uncertainty
that the 1954 Code was enacted, containing for the first time specific provisions
with respect to the sale of a patent.

It may be well at this stage to point out that the use of the past tense in the
above discussion does not mean that the material is of only historical significance,
because much of this prior law is applicable under section 1235 of the 1954 Code
and shall control transfers falling outside its limited scope. This is perhaps the
most important consideration to be kept in mind when handling the transfer of a
patent. The recently adopted regulations explaining the operation of section 1235
clearly indicate that section 1235 is not to be the exclusive means of obtaining
capital gain benefits but that other provisions of the internal revenue law will
apply to transactions not within its purview.\[41\] Thus it can be said that if a
payment is received in 1955, for example, the taxpayer would look first to section
1235. If he does not qualify under that section then, to obtain capital gain
treatment, within the meaning of the regulation that other portions of the
revenue law would apply, the taxpayer would look to section 1221. In applying

\[36\] Vincent A. Marco, supra note 17; United States v. Carruthers, supra
note 18; Kronner v. United States, supra note 13.

\[37\] Commissioner v. Hopkinson, 126 F.2d 406 (2d Cir. 1942).

\[38\] In a recent case the Second Circuit again had an opportunity to discuss
this question. But although the court listed the right to royalties as one retained
by the transferor, it did not consider it important in light of the "mass" of other
rights retained by the taxpayer. The court held the transaction a license without
reference to the Bloch decision. Watkins v. United States, 58-1 USTC 19321 (2d
Cir. 1958).

\[39\] 201 F.2d 621 (10th Cir. 1953).

\[40\] Vincent A. Marco, supra note 17; Crook v. United States, 135 F. Supp. 252
(W.D. Pa. 1955); United States v. Carruthers, supra note 18.

\[41\] U.S. Treas. Reg. §1.1235-1(b) (1957); see Leonard Coplan, 28 T.C. No. 141,
(September 20, 1957).
this section the case law developed under the 1939 Code, i.e. section 117 (which section 1221 reenacts), would be controlling.

With this alternative procedure in view, we proceed to the discussion of the 1954 statute.

**CAPITAL GAIN AND THE 1954 CODE**

The governing provision of the Internal Revenue Code relating to the sale of a patent is section 1235. This section is applicable to payments received after January 1, 1954, regardless of when the actual transfer was made. The focal point of the present statutory scheme is section 1235(a) which in essence provides that a transfer, other than by gift, inheritance or devise, of all substantial rights to a patent by any holder shall give rise to long-term capital gain benefits regardless of the periodic or contingent nature of the payments. This apparently favorable treatment would seem merely an extension of the aforementioned policy announced in the legislative history of the Revenue Act of 1950.\(^{42}\)

**What transfers will qualify?**

In order to qualify for capital gain treatment, the transfer must be of all substantial rights to a patent or of an undivided interest therein. The newly adopted regulations inform us that two types of transfers are clearly not transfers of all substantial rights; those limited by the agreement to a period less than the remaining life of the patent and those transfers in which there is a retention of the right to terminate at will.\(^{43}\) On the other hand, and consistent with the interpretation given transfers under the prior law, it is clear that the retention of rights by the transferor to secure payment or performance, in a transfer granting exclusive power to make, use and sell, or the retention of a security interest, would not invalidate the transfer.\(^{44}\) Except for these specific guides, the determination of whether the transfer is of all substantial rights must be made in light of all of the surrounding circumstances. The question is whether the transferor has retained rights inconsistent with the passage of ownership.\(^{45}\) Of particular significance in answering this question are the cases decided under the 1939 Code, since the test has its roots in these decisions and the legislative history of the present section indicates the desire to retain it.\(^{46}\)

\(^{42}\) See note 33 supra.
\(^{46}\) "It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner would be transferred." U.S. CONG. & AD. NEWS 5082 (1954).
With respect to the transfer or retention of an undivided interest in the patent, the regulations may have an impact on the prior law. In addition to prohibiting a transfer of only the rights to income from a patent, the regulations state that an undivided interest shall not include a license limited geographically, or, more important, a license covering only some of the valuable uses inhering in the patent.\(^\text{47}\) It is submitted that, while its meaning in this context is not altogether clear, the provision relating to a license limited geographically is not intended to overrule the \textit{Waterman} doctrine or the cases subsequently deciding that a transfer of exclusive rights to a whole patent could be limited, for example, to the United States. The provision pertaining to license covering only some of the valuable uses should be taken to mean that if a \textit{competitive} use is retained by the transferor, he has not parted with an undivided interest in the patent. On this basis, practitioners should proceed with caution if they intend to insert into an agreement what were formerly denominated license back clauses, particularly if the use, in effect, retained could be equated as competitive with the rights transferred.

While section 1235(a) refers to the transfer of rights to a patent, the regulations provide that it is not necessary that the patent be in existence or even applied for and therefore the inventor can sell what is tantamount to an inchoate interest in the patentable property.\(^\text{48}\) However it is implicit that capital gain benefits hinge upon a patent ultimately being issued.

In the above respects, there is substantially little difference between a transfer that qualifies under section 1235 and a transfer qualifying under the 1939 Code. But here the similarity ends.

A further requirement for a valid transfer is set forth in subsection (d) of section 1235, wherein it is stated that the benefits of section 1235(a) shall not apply to a transfer to persons "related" within section 267(b), except that brothers and sisters are excluded from this "related" category. Apart from any spousal, ancestral or lineal relationship, "related" significantly includes, \textit{inter alia}, a corporation in which the transferor owns more than 50 per cent in value of the outstanding stock. For purposes of computing the percentage, stock held by "related" persons within section 267(b) is deemed to be owned by the transferor. It is to be noted that a proposed amendment to section 1235(d)\(^\text{49}\) would reduce the prohibited percentage of ownership to 25 per cent. This amendment also emphasizes the brother and sister exception by providing that for purposes of

\(^{47}\) U.S. Treas. Reg. §1.1235-2(c) (1957); see Rev. Rul. 57-40, I.R.B. 1957-5, 20 as to options to acquire interests in a patent.
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section 1235 the stock held by these collaterals shall not be considered. However this interpretation is already acceptable under the present section.50

A final significant point to be considered with respect to a transfer under section 1235 is the mode of payment. The section expressly asserts that capital gain treatment shall be realized regardless of whether or not the payments received for the transfer are payable periodically over a period generally coterminous with the transferee's use of the patent, or are contingent on the production, use or disposition of the property. This position signifies a disregard for the unwavering contention of the Commissioner that such periodic or contingent payments are the payment of royalties and taxable as ordinary income,51 and there is no question but that this was the intent of Congress.52 Norwithstanding this clear expression of legislative intent, the Commissioner in 1955 reaffirmed his position by making the prior ruling applicable to payments received between June 1, 1950 and the effective date of the 1954 Code.53 In response to this Congress retroactively amended the 1939 Code to incorporate therein the provisions of section 1235 as section 117(q).54 The problem however remains since the Commissioner will undoubtedly take this position as to any transfer not qualifying under section 1235 or section 117(q).

Though the transaction may otherwise qualify under section 1235(a), that section states that the transfer must be made by a holder.

Who qualifies as a holder?

Section 1235(b) defines two categories of individuals who are to be deemed holders. The first category includes any individual who created the property.55 This, contrary to prior law, will include professional as well as amateur inventors but manifestly excludes entities such as corporations, trusts, or partnerships.56 The second category includes any individual investor acquiring his interest for consideration paid to the creator prior to the actual reduction to practice of the invention, provided such individual investor is neither the employer of the creator or "related" to the creator within the aforementioned limitations of

51. See note 31 supra.
52. "To obviate the uncertainty caused by this mimeograph and to provide an incentive to inventors to contribute to the welfare of the Nation, your committee intends ... to give statutory assurance to certain patent holders that the sale of a patent ... shall not be deemed not to constitute a 'sale or exchange' for tax purposes solely on account of the mode of payment." S. Rep. No. 1622, 83d Cong., 2d Sess., U.S. Cong. & Ad. News 5082 (1954).
56. The partnership cannot be a holder but each individual member may be qualified. U.S. Treas. Reg. §1.1235-2(d)(2) (1957).
section 1235(d), which applies section 267(b). The requirements that both the inventor and the investor be individuals and that the investor acquire his interest before the invention is actually reduced to practice represent the major departure from the prior law. The result is that in the great majority of transactions, the taxpayer will have to seek relief elsewhere.

While the term holder includes only an individual inventor and an individual investor who is not the employer of the inventor or "related" to him, this does not mean that these holders may not transfer their rights to a non-controlled corporation, for example, or that the inventor may not transfer his interests to his employer. However in the latter instance, apart from the practicalities of the situation that most inventions developed while in the employ of another become, pursuant to the employment contract, the property of the employer, the inventor-employee must face the difficult factual question of whether the payments were in reality compensation for services and thus ordinary income.57

Since section 1235(a) expressly treats a qualifying transaction as the sale of a capital asset held for more than six months, a holder will realize long-term capital gain without regard to the usual holding period. Impliendy, a loss on the transaction would result in long-term capital loss even though the section was intended as a relief measure for the inventor.

CONCLUSION

As noted, there seems to be little practical reason for a distinction between the tax treatment accorded a patent transfer and, for example, the transfer of a copyright. However Congress has expressly indicated a policy to stimulate inventive activity and therefore, after assuming the wisdom of such policy, the evaluation of section 1235 can be confined to an analysis of its effectiveness in furthering this policy. To its credit is allowing professional as well as amateur inventors to benefit, eliminating the holding period, and disregarding the Commissioner's position with respect to contingent payments. On the other hand, the requirements that the inventor and the investor be individuals, that the investor acquire his interest before actual reduction to practice, and that the transfer cannot be made to a corporation in which the transferor owns more than 50 per cent of the value of the outstanding stock, would all seem to militate against personal exploitation of the patent by the inventor which in the last analysis would seem the greatest incentive. The proposed amendment reducing the control factor to 25 per cent would all but prohibit personal exploitation in view of the constructive ownership provisions.

The key difficulty however is the requirement that the investor be an individual. Subsidization of an inventor's activity would seem to be the best means of promoting inventive activity particularly in view of the fact that an inventor's income, before the product of his efforts is realized, may often be meager. Such subsidization represents a deterring risk to an individual which could more easily be absorbed by entities desirous of fostering inventive activity from other than charitable motives.

Be this as it may, the concrete result of the intricate mechanism of section 1235, and the alternative possibilities under the prior law, is that practitioners must carefully evaluate the circumstances of the inventor and investor client. While capital gain benefits may ostensibly be easier to obtain under section 1235, the expansive possibilities of the prior law may be more advantageous.

George M. Gibson

CURRENT VIEWS ON THE TAXATION OF STOCK OPTIONS

The most effective means of compensating the corporate executive and other valuable employees in light of our present taxing structure is a problem which constantly commands the attention of corporate employers throughout the country. The ideal form of compensation of course is one which provides a maximum, non-taxable, economic benefit for the employee, and at the same time, allows a maximum deductible expense to the employer. Since absolute realization of this ideal is usually impossible under our present income tax code the problem becomes one of formulating compensation plans which most nearly approach it.

One of the most popular methods of tax-free compensation is the use of fringe benefits. These often include such items as country club memberships, various types of insurance benefits, company cars, interest free loans, expense accounts, and the like. In general this type of compensation is non-taxable to the employee, and at the same time it may be fully deducted by the employer. However, the economic benefits which may be conferred by this method are usually not substantial, and these plans are often subject to close scrutiny by the

58. The income spreading provisions of the 1954 Code are beyond the scope of this paper but should be consulted if there is a chance that a transaction will not qualify for capital gain benefits.

1. Int. Rev. Code of 1954, §§105-06. These sections deal with health and accident insurance plans and provide that, generally premiums paid by the employer as well as most benefit payments received by the employee are excludable from the employee’s gross income.