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CAPITAL GAINS TREATMENT ON PROCEEDS FROM PATENT TRANSFERS

INTRODUCTION

A frequently litigated question in the field of federal taxation is that of the right of an inventor to receive capital gains treatment on the proceeds from the sale of his patent. In 1954, Congress sought to alleviate some of the problems in this area by including a special provision in the new code by which an individual inventor could be assured of capital gains treatment. Although this new legislation has solved some of the problems, at the same time it has created others. This comment is an attempt to deal with some of the traditional problems in the light of the new legislation, and also to examine some of the questions which this new legislation has raised.

I. HISTORICAL BACKGROUND

As every student of the tax law is aware, Congress has long allowed special tax treatment to certain types of property known as "capital assets."[1] The present statutes[2] were derived from earlier law[3] with only minor changes.[4] In *Densmore v. Scofield*[5] the Supreme Court held that "patents rightfully issued are property;" and in *Edward C. Myers*[6] the Tax Court held that a patent could qualify as a "capital asset" as defined by the Internal Revenue Code. In 1942, section 117(j) was added to the Internal Revenue Code of 1939, enabling a taxpayer, with certain limitations, to treat the sale or exchange of depreciable property used in his trade or business as if it were the sale of a "capital asset."[7] Although this section was purportedly introduced to stimulate the sale of business properties so that they would be more apt to come into the hands of persons who would use them most efficiently for the war effort,[8] Congress apparently felt the section was of continuing usefulness for it was re-enacted as section 1231 of the Internal Revenue Code of 1954 without significant change.[9]

Subject to certain statutory conditions, generally under section 1231 a gain on the sale or exchange of real or depreciable personal property used in a trade

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1. Revenue Act of 1921, ch. 136, § 206, 42 Stat. 232.
2. INT. REV. CODE of 1954, §§ 1201, 1202, 1221.
3. Revenue Act of 1939, ch. 1, § 117, 53 Stat. 50 as amended.
4. H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954); 1954-3 *U.S. Code Cong. & Ad. News*, 4017, 4415.
5. 102 U.S. 375, 378 (1880).
6. 6 T.C. 258, 266 (1946).
7. INT. REV. CODE of 1954, § 1221(2) specifically excludes "property, used in a trade or business, of a character which is subject to depreciation" from the definition of "capital asset."
8. S. REP. No. 2375, 81st Cong., 2d Sess. (1950); 1950-2 *U.S. Code Cong. & Ad. News* 3053, 3105.
9. H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954); 1954-3 *U.S. Code Cong. & Ad. News* 4017, 4417.

or business and held for more than six months (*e.g.*, industrial equipment and real estate) is treated as a capital gain, but a loss is treated as an ordinary loss.[10] Although this section was held to be applicable to patents,[11] there has been a vast amount of controversy concerning the eligibility of patent transfers for treatment as capital transactions. The difficulty arises not in connection with the nature of the property itself, but rather in connection with the method by which it is transferred. Frequently the seller receives his consideration in the form of "royalties" over a period of time generally coterminous with the life of the patent, retaining a limited degree of control over the property until the full purchase price is paid. Hence there is a problem in meeting the requirement that there be a "sale or exchange" of the property.[12] The Commissioner maintained for a number of years that where consideration for the transfer of a patent was received in the form of "royalties" over a period conterminous with the life of the patent, the transactions must be treated as a "license" and could not constitute a "sale" within the meaning of the internal revenue statutes. The Commissioner's position was supported primarily by two early Supreme Court decisions in which purported patent assignments were held to be only licenses.[13]

In *Waterman v. MacKenzie*,[14] plaintiff was suing for infringement of a patent basing his right to sue on an agreement whereby the owner of the patent had granted to him ". . . the sole and exclusive right to manufacture and sell" under the patent. The defendant contended that plaintiff had no right to sue for infringement because he was a mere licensee. The Court held for the defendant on the ground that the agreement under which plaintiff claimed his right to sue was a license and not an assignment since there was no grant of the right to *use* the patented item. The Court noted that:

> The patentee or his assigns may, by instrument in writing, assign, grant and convey, either, 1st, the whole patent, comprising the exclusive right to make, use and vend the invention throughout the United States; or 2d, an undivided part or share of that exclusive right; or 3d, the ex-

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10. This is true when the taxpayer has only one transaction within the terms of section 1231 during the year. On the other hand, if the taxpayer engages in more than one transaction coming within the terms of section 1231, all gains and losses from these transactions are aggregated in the "hotchpot." If the hotchpot result is a net gain, then each transaction is either a capital gain or a capital loss; but if the hotchpot result is a net loss, then each of the transactions is treated as ordinary income or loss. Section 1231 differentiates between the taxpayer with a net gain and the taxpayer with a net loss in order to preserve ordinary loss treatment for taxpayers suffering the destruction or involuntary conversion of property that has declined in value, while permitting gains from such occurrences to be reported at the favorable capital gains rate. However, section 1231 as enacted went beyond this purpose, also embracing a sale or exchange of business property as well as an involuntary conversion.

11. General Spring Corp., 22 P-H Tax Ct. Mem. 770 (1953). *Accord:* Perkins v. United States, 216 F. Supp. 618 (D.N.J. 1963).

12. INT. REV. CODE of 1954, § 1231.

13. Waterman v. MacKenzie, 138 U.S. 252 (1891); United States v. General Electric, 272 U.S. 476 (1926).

14. Waterman v. MacKenzie, *supra* note 13.

> clusive right under the patent within and throughout a specified part of the United States. . . . A transfer of either of these three kinds of interest is an assignment. . . . Any assignment or transfer, short of one of these, is a mere license. . . .[15]

This language was cited in numerous cases as stating the basic criteria for the "sale" of a patent for federal income tax purposes, and the Commissioner consistently relied on it in a long line of cases to support his position that periodic payments received for the use of a patent could not qualify for capital gains treatment for want of a "sale or exchange."[16]

A turning point came in the case of *Edward C. Myers*.[17] The taxpayer had invented and patented a rubber-covered flexible steel track and in consideration of certain annual royalties based on a percentage of sales, had transferred the exclusive right to use, manufacture, and sell under the patent to B. F. Goodrich Rubber Company. The Commissioner argued that the taxpayer's retention of the right to terminate the agreement if a certain amount of royalty payments were not made, and the fact that the licensee had the right to terminate after a certain date, were completely inconsistent with a sale of the patent. This argument was rejected, and it was held that these were merely conditions subsequent which did not preclude the present passing of legal title. The Court quoted extensively from *Waterman v. MacKenzie*,[18] but distinguished it on the ground that there the licensee's exclusive rights did not include express authorization to use the invention, whereas there had been such authorization in the instant case.

Shortly after the decision in the *Myers* case the Commissioner acquiesced,[19] but four years later this acquiescence was revoked and non-acquiescence was substituted.[20] In the opinion accompanying this non-acquiescence the service clearly rejected the *Myers* decision, stating that in future cases where the owner of a patent transfers rights in consideration for payments based on a percentage of sales, or in consideration of periodic payments over a period essentially coterminous with the life of the patent, such a transfer was for tax purposes to be regarded as a provision for royalty payments, taxable as ordinary income.

Subsequent developments in 1950 (the year of the Commissioner's non-acquiescence) indicate that the Commissioner was not alone in his thinking that *Myers* had gone too far in protecting the taxpayer-inventor. In that year Congress enacted amendments to the Internal Revenue Code of 1939. Under these new

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15. *Id.* at 255.
16. Parke, Davis & Co., 31 B.T.A. 427 (1934); Julius E. Lilienfield, 35 B.T.A. 391 (1937); Claude Neon Lights, Inc., 35 B.T.A. 424 (1937); Comm'r v. Hopkinson, 126 F.2d 406 (2d Cir. 1942); Comm'r v. Celanese Corp., 140 F.2d 339 (D.C. Cir. 1944). It is interesting to note that *Waterman*, which was ironically not even a tax case, has been cited as authority in nearly every patent tax case involving the question of a "sale or exchange" within the past two decades.
17. 6 T.C. 258 (1946).
18. 138 U.S. 252 (1891).
19. 1946-1 CUM. BULL. 3.
20. Mimeograph 6490, 1950-1 CUM. BULL. 9.

sections, capital assets[21] and property used in a trade or business[22] were redefined to exclude a "copyright, a literary, musical, or artistic composition, or similar property" when held by the creator or one whose basis was determined by reference to the creator's basis. Congress considered the potential capital gains treatment of the income of amateur authors a "loophole" in the tax laws which they should close.[23] The House version of the bill also included "inventors" and "patents" in the same category but this portion of the bill was dropped in committee for the reason that ". . . the desirability of fostering the work of such inventors outweighs the small amount of additional revenue which might be obtained. . . ."[24] Although a reading of this committee report reveals that Congress had in mind only the individual inventor, subsequent developments do not reveal any attempts to withhold this advantageous tax treatment from corporations or other legal entities.

Sympathy for the individual inventor carried into 1954, when Congress felt it necessary, in view of the Commissioner's complete rejection of the *Myers* decision, to assure certain inventors that receipts from the transfer of their inventions would be eligible for capital gains treatment even though the method of payment was in the form of royalties. In addition, Congress felt the distinction under existing law whereby amateur inventors could potentially receive capital gains treatment but professional inventors could not (since they would be deemed to be holding the property for re-sale to customers) was an unfair distinction that should be eliminated.[25] Also eliminated was the six month holding period ordinarily required for long term capital gains treatment. Consequently, section 1235 of the Internal Revenue Code of 1954 provides that the individual inventor is eligible for long term capital gains treatment upon the transfer of all substantial rights to his patent regardless of whether he is in the business of inventing, the period held, or the method of payment.

There is little discussion in the committee reports as to why this section was limited to individuals, except for the notation that by the enactment of section 1235 Congress had ". . . no intention of affecting the operation of existing law in those areas without its scope."[26] The Commissioner's response to this enactment was the announcement that in all cases in which the newly enacted section 1235 was not applicable he would continue to oppose the *Myers* decision.[27] The Commissioner also noted that section 1235, as enacted, was applicable only to taxable years after December 31, 1953, and stated that he would refuse application of

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21. Int. Rev. Code of 1939, § 117(a)(1)(c); now INT. REV. CODE of 1954, § 1221(3).
22. Int. Rev. Code of 1939, § 117(j)(1)(c); now INT. REV. CODE of 1954, § 1231(b)(1)(c).
23. S. REP. No. 2375, 81st Cong., 2d Sess. (1950); 1950-2 *U.S. Code Cong. & Ad. News* 3053, 3097-3098.
24. *Ibid.*; 1950-2 *U.S. Code Cong. & Ad. News* 3098.
25. H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954); 1954-3 *U.S. Code Cong. & Ad. News* 4017, 4421.
26. *Ibid.*; 1954-3 *U.S. Code Cong. & Ad. News* 5084.
27. Rev. Rul. 55-58, 1955-1 CUM. BULL. 97.

Section 1235 to taxable years within the period between May 31, 1950,[28] and December 31, 1953.

In 1956, Congress, perhaps impressed by the Commissioner's obstinance, amended the Internal Revenue Code of 1939 to make the benefits of section 1235 of the 1954 Code available to taxpayers in taxable years after May 31, 1950, regardless of the year in which the transfer occurred.[29] This legislation apparently represented victory for the taxpayer for the Commissioner announced[30] that in view of several recent decisions by the Tax Court[31] he was re-considering his non-acquiescence in the *Myers* decision. He subsequently withdrew his non-acquiescence and agreed to follow the *Myers* decision in future cases.

With the Commissioner's acquiescence in *Myers* it appeared that the individual inventor might obtain capital gains treatment alternatively under sections 1221, 1231, or 1235. Similarly, the door was now open for a patent holder ineligible under section 1235 to look to sections 1221 and 1231 for capital gains treatment even though the consideration was to be paid in the form of royalties.

II. Is 1235 Exclusive?

Section 1235[32] by its terms applies only to individuals whose efforts created the invention or individuals other than relatives or employers who acquired an interest in the patent in consideration for money paid to the inventor prior to actual reduction of the invention to practice. Thus section 1235 applies to only a limited class of individuals. An important question is whether those individuals described as holders who do not otherwise qualify under section 1235 are precluded from seeking capital gains treatment under the general capital gains provisions of the law.

It should be pointed out that while several benefits are available to a taxpayer under section 1235,[33] the primary benefit which Congress had in mind in enacting that section was to insure the availability of capital gains treatment to an inventor even though he received compensation for the transfer of the patent in the form of royalties payable periodically over the life of the patent, or with payment contingent on the productivity or use of the patent by the transferee.[34]

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28. This was the date to which the Commissioner retroactively applied his non-acquiescence in *Edward C. Myers*, 6 T.C. 258 (1946). *See* textual matter accompanying footnote 19.

29. Int. Rev. Code of 1939, § 117(q). S. Rep. No. 1941, 84th Cong., 2d Sess. 3 (1956). Congress specifically noted that the enactment of this amendment was necessary to negate the effect of the Commissioner's ruling.

30. Rev. Rul. 58-353, 1958-2 Cum. Bull. 408.

31. Leonard Coplan, 28 T.C. 1189 (1957); Roy J. Champayne, 26 T.C. 634 (1956).

32. All further references to the "Code" (or to "sections" thereof) shall mean the Int. Rev. Code of 1954, as amended to date.

33. *E.g.*, no six month holding period, no disqualification for those in the "business" of inventing.

34. H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954); 1954-3 *U.S. Code Cong. & Ad. News* 4422.

This was in effect an expansion of the *Myers* decision,[35] which the Commissioner had refused to follow until section 1235 was enacted. Thus, when the Commissioner finally acquiesced in the *Myers* decision in 1958,[36] section 1235 was no longer necessary to accomplish the primary objective for which it had been enacted.

Until the recent case of *Myron C. Poole*[37] it had been tacitly assumed by the courts and the Commissioner that an individual inventor who was unable to satisfy the requirements of section 1235 would not be precluded from seeking capital gains treatment under the general capital gains provisions of the law. In *Leonard Coplan*,[38] the taxpayer-inventor was clearly ineligible for the benefits of section 1235[39] in view of the fact that he sought capital gains treatment on the proceeds from the sale of a patent to a 100% controlled corporation.[40] Neither the Commissioner nor the taxpayer made any argument that section 1235 should apply or that the existence of that section foreclosed the taxpayer from seeking capital gains treatment under the general provisions of the law. The Court, however, on its own initiative, noted that the Government could have argued that section 1235 was the exclusive means by which an individual inventor could receive capital gains treatment, and that considerable support for that position could be found in the legislative history of section 1235. The Court did not decide this question, however, and ruled in favor of the taxpayer on the ground that he had fulfilled the requirements for capital gains under the general provisions of the law.

Subsequent cases held in favor of the taxpayer on the ground that section 1235 did not preclude resort to the general capital gains provisions in cases where the taxpayer was unable to meet the requirements of that section.[41] The Commissioner appeared to agree with this position in 1957 when he issued his regulations under section 1235.[42] These regulations provide that section 1235 is to be disregarded in determining whether or not there has been a sale or exchange of a capital asset in cases not specifically within its terms. Cited as an example of a situation not

35. 6 T.C. 258 (1946).
36. Rev. Rul. 58-353, 1958-2 CUM. BULL. 408.
37. 46 T.C. 392 (1966).
38. 28 T.C. 1189 (1957).
39. This actually involved § 117(q), Int. Rev. Code of 1939, as amended, but as this section is identical with § 1235 of the 1954 Code, reference will be made to the latter section in this and all subsequent cases to avoid confusion.
40. Section 1235(d)(1) specifically excludes the benefits of that section to transfers between an individual and a 25% controlled corporation. At the time of this case the applicable figure was "more than 50%." Also, § 117(o), Int. Rev. Code of 1939 (the equivalent of § 1239 of the present Code) which precluded capital gains treatment of proceeds from a sale to a corporation in which the transferor and his family owned more than 80% of the corporate stock, was not applicable to this transfer, which occurred in 1950. That section applied only to transfers after May 3, 1951.
41. Herbert C. Johnson, 30 T.C. 675 (1958); Sheen v. United States, 167 F. Supp. 543 (E.D. Penn. 1958); George N. Soffron, 35 T.C. 787 (1961); Julian A. McDermott, 41 T.C. 50 (1963); James C. Hamrick, 43 T.C. 21 (1964).
42. 22 F.R. 8899, 1957-2 CUM. BULL. 570.

covered by section 1235 is ". . . a transfer by a holder to a related person . . . ,"[43] which is excluded from the benefits of section 1235 by 1235(d)(2). Several writers similarly concluded that section 1235 was not the exclusive means by which an individual failing to qualify under that section could receive capital gains treatment on the transfer of a patent.[44]

With this background it was surprising when the Tax Court in *Myron C. Poole*[45] held unequivocally that section 1235 is the *exclusive* means by which an individual inventor can receive capital gains treatment on the proceeds of a transfer of a patent interest as described in that section. The taxpayer in *Poole* was the inventor and holder of a patent on a window designed for use in mobile homes. He transferred his interest in the patent to a corporation in which he owned 50% of the stock and contended that he was entitled to the benefits of section 1235. The court held that while the taxpayer in form controlled only 50% of the stock, in substance he controlled all of it and thus was not entitled to the benefits of section 1235.

Alternatively, the taxpayer contended that he was entitled to capital gains treatment on his income by virtue of the general capital gains provisions of the law. The court rejected this argument, and held that for any transaction which is described in section 1235(2), that section is the exclusive means by which a "holder" as defined in the section can obtain capital gains treatment on the proceeds from the sale of a patent. The court recognized that the regulations suggest a different result but based its holding on the legislative history of section 1235.

Although the *Poole* decision is unfavorable to the taxpayer-inventor, the result does seem to reflect the legislative purpose behind section 1235. The House Committee Report on this section states 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 (retroactively, if necessary) in the entire transaction being taxed to him as resulting in ordinary income.[46]

Similar language is found in the Senate Report on this code section.[47] Also, the committee reports on the 1958 amendment[48] to section 1235 contain language generally consistent with that of the House Committee Report.[49]

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43. Treas. Reg. § 1.1235-1(b) (1957).
44. Porter, *Capital Gains on Patents Without Benefit of Section 1235,* 41 TAXES 800 (1963); Bailey, *The Inventor,* 15TH ANNUAL N.Y. UNIV. INST. ON FED. TAXATION 285 (1957); Mann, *Summary of Prevailing Case Law on Tax Aspects of Sales or Exchange of Patent Rights,* 40 TAXES 767 (1962).
45. 46 T.C. 392 (1966).
46. H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954); 1954-3 *U.S. Code Cong. & Ad. News* 4017, 4422.
47. S. REP. to accompany H.R. 8300; 1954-3 *U.S.Code Cong. & Ad. News* 4621, 5081.
48. This amendment to § 1235(d) changed the exclusionary provision of § 1235 from transfers to "more than 50%" controlled corporations to transfers to "25% or more" controlled corporations.
49. H.R. REP. No. 1983, 85th Cong., 2d Sess. 3 (1958).

The committee reports that support the decision in the *Poole* case also offer some explanation for the earlier decisions[50] of the courts on the issue of whether section 1235 is exclusive. Congress made it clear in enacting section 1235 that it did not intend to preclude capital gains treatment under existing law in the case of those individuals and types of transfers not qualifying under that section.[51] But individuals who are described as "holders," while failing to meet other requirements of section 1235 have argued that their transfers were beyond the scope of that section. They have relied on statements such as "In enacting this section . . . your committee has no intention of affecting the operation of existing law in those areas without its scope"[52] to support their contention that failure to qualify under section 1235 does not preclude them from resorting to other capital gains provisions of the law. While this statement could be taken as authority for the proposition that section 1235 is in no way exclusive, it is evident from the legislative history as a whole that the intent of Congress *was* to make 1235 exclusive in the case of transfers described in 1235(a) by *"holders"* as defined in 1235(d). It is not, on the other hand, the exclusive means for obtaining capital gains treatment on transactions outside the scope of section 1235.

The *Poole* case is of particular significance in that it is often desirable to employ the corporate form of doing business to insure the success of any new invention. The personal desires of the individual inventor may make it desirable in many instances to limit the shareholders to members of the family, but under the provisions of section 1235(d) the individual will be precluded from the benefits of that section on a transfer to a corporation in which he and the members of his family own more than 25% of the corporate stock. In addition, under the *Poole* decision he will be precluded from receiving capital gains treatment on such a transfer under the general provisions of the law.

The problem is further complicated by the fact that it is unlikely that the taxpayer will be able to avoid the effect of the *Poole* case by having the patent issued in the name of a corporation or other legal entity. Under the patent laws application for a patent must be made in the name of the original inventor.[53] While the statutes permit the patent to issue in the name of an assignee of the inventor,[54] the fact that the original application must be made in the name of the individual inventor would almost certainly preclude the taxpayer from avoiding the effect of *Poole* (and the statutory policy it represents) in this manner.

III. What Constitutes a Sale of a Patent?

A. *The Significance of Section 1235*

The basic requirement of both sections 1235 and the general capital gains provisions is a "sale" of—or, in 1235 terminology, a transfer of "all substantial

50. Cases cited footnote 42 *supra.*
51. H.R. Rep. No. 1337, 83d Cong., 2nd Sess. 3 (1954).
52. *Ibid.;* 1954-3 *U.S. Code Cong. & Ad. News* 5082.
53. 35 U.S.C. § 111 (1952).
54. 35 U.S.C. § 152 (1952).

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rights" to—the patent. Of major concern in this regard are the questions of what rights a transferor of a patent may retain and still meet the requirement of a sale, and of what differences there are between section 1235 and the general capital gains provisions with regard to this requirement. The following discussion is necessarily limited to the more commonly encountered problems and is not meant to be exhaustive of all of the potential problems.

Since the Commissioner has set forth regulations[55] as to what will qualify as a transfer of "all substantial rights" under section 1235, there has been a tendency to rely on these regulations in determining what constitutes a "sale or exchange" under the general capital gains provisions in instances where transfers by "holders" are not involved. A careful reading of the two sections and the legislative history raises the question of whether this reliance is proper. Although Congress stated that the criteria to be used in determining whether there was a transfer of "all substantial rights" to a patent under section 1235 were the same as those which had been used to determine the issue of "sale or exchange" under prior law,[56] at the same time limitations were imposed on the scope of section 1235 which were not found in prior law.

In describing the term "undivided interest" as it is used in section 1235, the committee reports stated that it was to include those interests which included ". . . a part of each property right represented by the patent . . . (and not, for example, a lesser interest such as a right to income, or a license limited geographically, or a license which conveys some, but not all, of the claims or uses covered by the patent)."[57] This characterization is more narrow than the basic test outlined in *Waterman v. MacKenzie*[58] and reaffirmed in *Edward C. Myers.*[59] In keeping with this legislative purpose, the regulations[60] specifically disallow capital gains treatment for a transfer of patent rights limited geographically or industrially or to a transfer which covers some but not all of the claims or inventions covered by the patent. All of these limitations have been held not to preclude a sale of a patent in cases where section 1235 was not applicable.[61]

B. *Geographical Limitations on the Rights Transferred*

Following the language of the Supreme Court in *Waterman v. MacKenzie,*[62] subsequent cases have generally sustained capital gains treatement on patent transfers even though the transferee's rights are subject to specific geographical limitations. This was the result where the taxpayer entered into two essentially

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55. Treas. Reg. § 1.1235 (1957).
56. H.R. REP. No. 1337, 83d Cong., 2d Sess. 3 (1954); 1954-3 *U.S. Code Cong. & Ad. News* 5334.
57. *Id.* at 5082.
58. 138 U.S. 252 (1891).
59. 6 T.C. 258 (1946).
60. Treas. Reg. § 1.1235-2(b)(c).
61. *See* discussion *infra,* pt. III, §§ B, C, of this comment.
62. Dunn, *Tax Considerations in Patent Assignments and Licenses between Related Corporations,* 16 TAX. L. REV. 315 (1961).

identical agreements for the transfer of the exclusive right to manufacture, use, sell, and distribute under certain patents held by him—one agreement for exclusive rights throughout the United States east of the Mississippi River, the other for the same rights west of the river.[63] Similarly, the transfer of all exclusive rights under a patent ". . . within the United States" was held to be a sale of that portion of the patent and not a mere license.[64] In another case where the issue was whether or not an industrial limitation on a patent transfer would preclude a sale, the Commissioner conceded that a geographical limitation would be permissible.[65] This same privilege is expressly withheld from the 1235 "holder" by regulations[66] in keeping with the intent of Congress in enacting that section.[67]

C. *Industrial Limitations and Other "Carved Out" Interests*

1. Industrial

In *United States v. Carruthers,*[68] the taxpayer assigned all rights under the patent owned by him to a corporation, but limited their use to the canning industry. The Commissioner contended that the reservation of the right to grant exclusive rights in other industries was inconsistent with a sale and thus construed the agreement as a license. The court quoted from *Waterman v. MacKenzie,*[69] noting that the Commissioner accepted the rule that an agreement limited geographically would still be a sale if all rights under the patent within a specified area were transferred. Holding for the taxpayer, the court stated: "No explanation has been attempted by appellant [Commissioner], nor has it proffered any policy argument as to why a transfer enveloping *an industry* should be given such different tax treatment from a transfer encompassing an area."[70]

In *American Chemical Paint Company v. Smith,*[71] an excess profits tax case, handed down shortly after the *Carruthers* decision, the taxpayer had reserved all rights to the patent ". . . in fields outside the general field of usefulness . . ." as described in the agreement. Holding for the Commissioner, the court distinguished *Carruthers* on the ground that the court in *Carruthers* had specifically recognized that there was no evidence that the invention had any value for any purpose other than processing tuna, and thus, even though the assignment was limited to that particular industry, it was in fact a transfer of all rights under the patent. It ap-

63. Vincent A. Marco, 25 T.C. 544 (1955). This case involved tax years before the effective date of § 1235.
64. Watson v. United States, 222 F.2d 689 (10th Cir. 1955). This case involved tax years prior to the effective date of § 1235.
65. United States v. Carruthers, 219 F.2d 21 (9th Cir. 1955). This case involved tax years prior to the effective date of § 1235.
66. Treas. Reg. § 1.1235(2)(6)(1).
67. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. (1954); 1954-3 *U.S. Code Cong. & Ad. News* 5082.
68. 219 F.2d 21 (9th Cir. 1955).
69. 138 U.S. 252 (1891).
70. 219 F.2d 21, 24 (9th Cir. 1955).
71. 131 F. Supp. 734 (E.D. Pa. 1955).

pears the same result could have been reached without limiting the scope of *Carruthers* for the taxpayer had also placed a geographical limitation[72] on the transfer.

These two cases do raise the important question of whether the courts should distinguish, for federal tax purposes, between industrial and geographical limitations in patent transfers. Courts that have upheld sales of patent interests subject to geographical limitations have invariably done so on the unquestioned authority of *Waterman v. MacKenzie,* and most of the arguments against permitting industrial limitations have been based on the premise that *Waterman* did not recognize such a limitation. Surprisingly, no court has sought to analyze the rationale of the *Waterman* decision. The Supreme Court in deciding that case, an infringement suit, relied upon the statute dealing with patent ownership and assignment[73] in holding that a conveyance of ". . . the exclusive right under the patent throughout a specified part of the United States" constituted an assignment. Similar language is contained in the present statute,[74] and courts in areas other than the tax field have generally held that anything short of an "assignment" as defined in *Waterman v. MacKenzie* will be construed as a license.[75] In view of the fact that *Waterman* was not a tax case and that general principles of law are not necessarily controlling in the tax field, the question remains whether the test set forth in that decision should invariably be conrollling in tax cases. The court in *Carruthers*[76] had answered this question in the negative. Following this rationale, the soundness of the distinction between the transfer of patent rights subject to geographical limitations and the transfer of these rights subject to industrial limitations would seem questionable, since both transfers would have economic consequences similar to a transfer of an "undivided interest." A transfer of all rights under a patent as they may be used in the "canning industry" may represent as complete and unequivocal relinquishment of rights as the transfer of an undivided one-half interest. A transfer of an undivided interest is specifically recognized as the equivalent of a sale for purposes of section 1235.[77]

Notwithstanding the decision in *American Chemical Paint Company,* several

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72. The taxpayer had reserved "[t]he right to manufacture in the United States and Canada for sale and use only in countries other than the United States and Canada, materials covered by any of the inventions and discoveries and patent applications and patents included or to be included in this license agreement." *Id.* at 738.

73. REV. STAT. § 4898 (1875), derived from Act of July 8, 1870, c. 230, § 36, 16 Stat. 203.

74. 35 U.S.C. § 261 (1954) states: "The applicant, patentee, or his assigns or legal representative may in like manner grant and convey an exclusive right under his application for patent, or patents, to the whole or any specified part of the United States."

75. Kenyon v. Automatic Instrument Co., 160 F.2d 878 (6th Cir. 1947); Doherty Research Co. v. Vickers Petroleum Co., 80 F.2d 809 (10th Cir. 1936).

76. 219 F.2d 21 (9th Cir. 1955).

77. Treas. Reg. § 1.1235-2(c) (1957) defines an "undivided interest" in all substantial rights to a patent as the same fractional share of each and every substantial right to the patent.

decisions in cases involving transfers limited to specific industries or uses have followed *Carruthers*.[78] And the same result was reached where the transfer involved the grant of the exclusive right to manufacture, use, and sell one of several compounds in a class.[79] Apparently other compounds covered by the patent were equally valuable. Citing the *Carruthers* case, and reasoning that the effect was analogous to a transfer limited industrially, the court held that there could be a sale for tax purposes of one of several claims represented by a single patent.

2. Other "Carved Out" Interests—Impact of 1235

In *Allied Chemical Corporation v. United States*,[80] the transfer involved a patent covering an anti-fungus wrapper which could be used for several different purposes. The transfer agreement had expressly limited the use of the patent to the cheese wrapper industry. Although holding that there was not a sale of even a part of the patent rights in this case since the taxpayer had retained the "substantial right" to license others in the same field in which it had allegedly sold its rights under the patent, the court recognized that ". . . a transfer of a single claim or a single field of use covered by a patent may be accorded capital gains treatment. . . ."[81]

The Commissioner cited the regulations under section 1235 as authority for his position that a transfer of patent rights limited to a particular industry could not qualify for capital gains treatment. The court, however, distinguished the requirements of section 1235 and of section 1231 for the sale of a patent, noting that section 1235 was not applicable to the present case involving a corporate taxpayer.

Two cases arising under section 1235 reached the conclusion that a transfer of rights limited to a particular claim under a patent may still qualify under section 1235 for capital gains treatment, in clear contradiction of the regulations. In one,[82] the deceased inventor had invented a "closure valve" which was intended to have wide application in all types of pressure vessels and pipelines including but not limited to "gate valves." In a subsequent assignment of rights under the patent it was specifically noted that "The license granted herein is nonexclusive as to the entire invention, but is exclusive so far as the invention can be applied to gate valves. . . ."[83] In the other,[84] the Tax Court stated that the question before it was whether "a patent or patent application may be separated into different fields of application, and whether each field can be transferred to a different transferee with the transfer being considered under section 1235(a) as

78. Commercial Solvents Corporation, 42 T.C. 455 (1964); Bannister v. United States, 262 F.2d 175 (5th Cir. 1958); First National Bank of Princeton v. United States, 136 F. Supp. 818 (D.N.J. 1955).
79. Merck & Co., Inc. v. Smith, 261 F.2d 162 (3rd Cir. 1958).
80. 17 Am. Fed. Tax R.2d 316 (S.D.N.Y. 1966).
81. *Id.* at 321.
82. Estate of Milton P. Laurent, Sr., 34 T.C. 385 (1960).
83. *Id.* at 388.
84. William S. Rouveral, 42 T.C. 186 (1964).

a sale or exchange of a capital asset."[85] Again the court answered in the affirmative.

Under other circumstances the decisions in these two "1235 cases" would be heralded as a major gain for taxpayers who must meet the requirements of section 1235. But in view of the clear statement in the committee reports that Congress did not intend for the benefits of section 1235 to be available in the case of ". . . a license which conveys some, but not all of the claims or uses covered by the patent,"[86] it would seem apparent that these decisions are directly contrary to the Congressional intent. Furthermore, in light of the *Poole* case,[87] the Tax Court may be reexamining other aspects of patent transfers, and it is evident that prior case law will not preclude a change in position to conform with the legislative purpose. For these reasons it is suggested that these two decisions are very questionable authority.

D. *Retention of Title by the Transferor*

Although the regulations state that retention of bare legal title by the transferor will not preclude a sale of a patent under section 1235,[88] the Commissioner has frequently argued in cases arising under the general capital gains provisions of the law that retention of title by the transferor indicates that there has been no sale of an interest in a patent. Judicial comment on the point is not abundant. In *Parke, Davis & Company*,[89] however, the court noted that for tax purposes the inquiry should concern the ownership of the beneficial interest rather than of the legal title. "Legal title alone, without beneficial ownership, and held for the interest of another, is without value. . . . Unquestionably, an equitable interest in patents is subject to transfer."[90] Similarly, in *Carl G. Dreymann*[91] the court noted that the transferee's "right to legal title was specifically enforceable in equity, and, as of the time her equitable title vested, she had a right, title and estate in and to property."[92] Consequently, although retention of legal title by the transferor may be a significant factor it is clearly not sufficient alone to prevent the establishment of a sale.

E. *Prohibitions Against Sub-licensing and Sub-assignment*

It is often advantageous for the transferor to restrict the transferee's rights to sub-assign and sub-license under the patent, especially where the transferor retains an interest in the patent. The regulations state that retention by the trans-

85. *Id.* at 192.
86. S. Rep. To Accompany H.R. 8300, 83d Cong., 2d Sess. (1954); 1954-3 *U.S. Code Cong. & Ad. News* 5082. *See* discussion pt. III, § A, of this comment.
87. Myron C. Poole, 46 T.C. 392 (1966). *See* discussion *supra* pt. II.
88. Treas. Reg. § 1.1235-2(b)(2)(i) (1957).
89. 31 B.T.A. 427 (1937).
90. *Id.* at 431.
91. 11 T.C. 153 (1948). This case involved tax years before the effective date of § 1235.
92. *Id.* at 160.

feror of the right to prohibit sublicensing or subassignment by the "may or may not" preclude a sale for purposes of section 1235 ". . . depending upon the circumstances of the whole transaction . . . ."[93] Such limitations on the transferee's rights have generally been held not to preclude a sale for tax purposes of an interest in a patent. But there was no sale where the transferor had reserved the power to disallow any sublicensing agreement and numerous and extensive other rights.[94] Similarly, in *Allied Chemical Corporation v. United States*,[95] the transferor not only controlled the transferee's sublicensing, but also retained the power to sublicense others in the same field in which the transferee had been licensed.

However, it seems likely that in most cases where the transferor simply restricts the transferee's right to sub-license or to sub-assign the patent interest, this will not prevent a sale. For example, where the taxpayer had transferred certain patents subject to his right to disapprove any licensing agreement between the transferee and a third party, the court held for the taxpayer. The court found that this limitation did not substantially impede the transferee's otherwise absolute dominion over the property, and that it was in fact a reasonable safeguard against the transferee's intentional avoidance of royalty payments by curtailing his own production in favor of licensing others.[96]

A similar example[97] involved a restriction on subassignment. The taxpayer granted the exclusive right to manufacture, use, and sell a patented invention in return for royalty payments of 1% of sales. The court held for the taxpayer, noting that "It is significant that there was in the instant case unlimited right to sublicense. . . . The prohibition against complete assignment of the license contract without licensor's consent is understandable where the payment for the transfer of the total rights is to depend on future profits from manufacture and sale."[98] This case is representative of the weight of authority on this issue. However, the language emphasizing that the transferee did have the unlimited right to sublicense should probably not be taken as a limitation on the holding, as other courts have not appeared to recognize this limitation.[99]

F. *Transferor's Right to Terminate; Time Limitation on the Rights Transferred*

In the leading case of *Edward C. Myers*,[100] the taxpayer retained the right to terminate the agreement if a certain amount of royalties were not paid. The

93. Treas. Reg. § 1.1235-2(b)(3) (1957).
94. Watkins v. United States, 149 F. Supp. 718 (D. Conn. 1957). This case involved tax years both before and after the effective date of § 1235.
95. 17 Am. Fed. Tax R.2d 316 (S.D.N.Y. 1966).
96. Thompson v. Johnson, 42 Am. Fed. Tax R. 1284 (S.D.N.Y. 1950). This case involved tax years before the effective date of § 1235.
97. Carroll Pressure Roller Corporation, 28 T.C. 1288 (1957).
98. *Id.* at 1293.
99. Watson v. United States, 222 F.2d 689; Allen v. Werner, 190 F.2d 840 (5th Cir. 1951); First Nat'l Bank of Princeton v. United States, 136 F. Supp. 818 (D.N.J. 1955); Bell Intercontinental Corporation v. United States, 20 Am. Fed. Tax R.2d 5153 (Ct. Cl. 1967).
100. 6 T.C. 258 (1946).

agreement also gave to the transferee the right to terminate on sixty days written notice. The court rejected the Commissioner's argument that these provisions were incompatible with a sale of the patent and held that they were mere "conditions subsequent" which did not interfere with passage of title. The regulations[101] specifically recognize that retention by the transferor of rights ". . . in the nature of a condition subsequent . . ." will not preclude a sale of a patent interest under that section.

An opposite result was reached, however, where the taxpayer had entered into an agreement which he claimed was a sale of a patent interest but which was terminable at the will of the transferor after six months.[102] Similarly, the limits of the *Myers* decision had been tested in an earlier case[103] where the taxpayer claimed capital gains treatment on proceeds from the transfer of patent rights to a corporation under a one year agreement subject to cancellation by either party at any time during the year on sixty days notice. The court held summarily that the retention of such an extensive right by the transferor was indicative of a license rather than a sale.

The distinction between *Myers* and these other decisions was clarified in the case of *Bell Intercontinental.*[104] One of several agreements in issue involved the transfer of a patent for consideration in the form of royalties, where the agreement was terminable at the will of the transferor after ten years. The court held for the government, noting that ordinarily the transfer of an interest in a patent terminable at the will of the transferor would constitute a license. The court stated that only if it could be shown that this right had no practical value, or if the agreement was terminable only on the occurrence of some future event beyond the control of the transferor, would it be construed as a condition subsequent to a sale.[105] In *Myers,* for example, the transferor's right to terminate had been conditioned upon the failure of the *transferee's* royalty payments to be a certain amount.

G. *Limitations on the Transferee's Right to Sue for Infringement*

Although the courts have not accepted the argument that the retention of the right to sue for infringement necessarily precludes the finding of a sale, the courts have on occasion accepted the fact that the right *was transferred* as evidence of a sale where otherwise they might have found only a license.

In *Parke, Davis & Co.,*[106] the agreement in question provided that the taxpayer-assignor was to take appropriate legal action to enjoin any infringement

101. Treas. Reg. § 1.1235-2(b)(2)(ii) (1965).
102. Arthur M. Young, 29 T.C. 850 (1958). This was a "1235 case."
103. Lynne Gregg, 18 T.C. 291 (1952), *aff'd* 203 F.2d 954 (3rd Cir. 1953). This case involved tax years prior to the effective date of § 1235.
104. Bell Intercontinental Corp. v. United States, 20 Am. Fed. Tax R.2d 5153 (Ct. Cl. 1967).
105. *Id.* at 5163.
106. 31 B.T.A. 427 (1934).

(taxpayer had retained legal title), but that the cost of such litigation as well as any recovery was to be shared equally by the transferee to whom a one-half interest in the patent had been transferred. The court held that retention of legal title was not inconsistent with a sale, and neither was the right to sue for infringement where suit was to be brought for the benefit of the transferee and costs and recovery were to be borne by him and received by him in proportion to his interest. Under such circumstances, the taxpayer retained only bare legal title. The court emphasized that the right to maintain a suit at law is often controlled by the question of possession of "naked legal title" but that questions of income tax liability should turn instead on possession of beneficial interest.

The same result was reached where the transferor of a patent interest had expressly agreed to defend at its own expense any patent infringement suits brought against the transferee and to reimburse it for any financial losses resulting therefrom.[107] The court noted that there was no inconsistency between passage of title and the transferor's obligation to defend assaults upon the purchaser's title, such covenants being common provisions in most real property conveyances. But reservation by the transferor of the right to sue for infringement where the transferor retains numerous other rights is one factor in determining whether there is a sale.[108] As the court in *Oak Manufacturing Company v. United States*[109] stated, the right to control infringement suits was only one of a "substantial bundle of sticks" retained by the transferor which precluded a sale of the patent.

On the other hand, the right in the transferee to sue for infringement may be indicative of a sale.[110] Thus where the agreement stated: "This agreement shall be construed as a license of the aforesaid patents and not an assignment thereof. . . . ,"[111] the Commissioner strenuously argued that the language was so clear and unambiguous that this could not possibly be considered a sale. But an examination of the agreement as a whole made it clear that in spite of the language of the parties the intent was clearly to transfer all beneficial interest to the licensee. The court noted that, in addition to having exclusive rights under the patent with regard to use, manufacture, and sales, it was "very significant" that the licensee possessed the right to enforce the patent rights in his own name, retaining as his own any recoveries.[112] These cases were decided before section 1235 had become effective, or involved taxpayers not eligible under that section, but it seems likely that a similar approach would also be adopted in a case arising under section 1235.[113]

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107. First Nat'l Bank of Princeton v. United States, 136 F. Supp. 818 (D.N.J. 1955).
108. Oak Manufacturing Co. v. United States, 301 F.2d 259 (7th Cir. 1962); Lynne Gregg, 203 F.2d 954 (3rd Cir. 1953).
109. 301 F.2d 259 (7th Cir. 1962).
110. Pike v. United States, 101 F. Supp. 100 (D. Conn. 1951).
111. *Id.* at 101.
112. *Ibid.*
113. The regulations under § 1235 do not mention the question of the possible effect of the retention of the right to sue, or of the obligation to defend, upon the existence of a "sale or exchange" under § 1235.

H. *Limitations on the Number of Rights Retained*

Although it may be stated as a general proposition that retention by the transferor of the rights here discussed will not preclude a sale of the patent for tax purposes, it must be borne in mind that any individual case must be decided on its facts, and it is not suggested that in any given case every one of the rights mentioned in the foregoing discussion could be retained. On the other hand, it is clear that several of the rights herein mentioned may remain in the transferor without precluding a sale.[114]

IV. Conclusion

The tax law in the field of patent transfers has shown a tendency to develop favorably for the taxpayer. The decision in *Myron C. Poole*[115] that the individual inventor qualifying as a "holder" under section 1235 will henceforth have to look exclusively to that section in order to receive capital gains treatment shows, however, that such a trend is not inexorable.

It is probable that the law in this area will eventually draw a clearer distinction between the requirements for capital gains treatment under section 1235 and the requirements under the general capital gains provisions of the law. It is now established that the transferor of a patent may retain legal title, impose time limitations, or retain various other rights such as the right to license others in certain geographical areas or industries, the right to prohibit subassignments and sublicenses, or the right to control infringement litigation, without precluding a "sale or exchange" of the patent under the general capital gains provisions. On the other hand, it is clear that capital gains treatment under section 1235 will be denied to transfers which are limited geographically or industrially.

J. David Wharton

114. First Nat'l Bank of Princeton v. United States, 136 F. Supp. 818 (D.N.J. 1955); Edward C. Myers, 6 T.C. 258 (1946).
115. 46 T.C. 392 (1966).