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Sale of Patents and Inventions

Facts

Client while on the staff of a European University developed certain inventions. It would seem that these inventions were incidental to his work at the University and not part of his duties. United States and British letters patent were applied for in respect of certain of the inventions and in December, 1936, after one of the British patents had been issued but while the other applications were pending, the client entered into a license agreement with Mr. Izbert Adam pertaining to the inventions covered by the applications and patents and also future inventions. The license agreement was exclusive in part and non-exclusive in part. The contract called for payment of $14,610. The licensee also was required to pay royalties under the contract and in addition to make certain further payments for the right to use further developments. Adam, after paying the sum of $14,610, brought suit for rescission and damages. The suit was settled by payment of a compromise sum paid partly in 1943 and partly in 1944 and the release by Adam of any rights in the patents and inventions.

At some time not later than 1938 client became a resident of the United States and is now a naturalized citizen.

From March 1, 1939 until November 1, 1940 client did experimental work at Columbia University as a research guest. Certain researches were published. During that period, the inventions were made, but no patents were applied for nor was the research intended to be an inventive activity. In letter to the Government fixing his price for the inventions he stated that he devoted himself solely to this field and received no financial consideration from any source. Commencing November 1, 1940 to date, he has been engaged in experimental work at Columbia and at the University of Chicago. For this he is being paid a salary.

Client in 1943 sold the patents. On his return for 1943 he treated the payments to Adam and expense of litigation as "other decuctions" and the receipt from the sale of the patents less certain costs as capital gain.

In December, 1943, a contract for the sale of the inventions developed at Columbia to the United States Government was signed by the client, in duplicate, and delivered to representatives of the Government. We are to assume that this contract contained a present assignment of all rights on the inventions. Some time later in 1944 one copy of this contract, signed by the Government, was delivered to the client. Payment has not as yet been made under this contract.

Client makes his returns on a cash basis.

Questions and Our Opinions

1. Is the income tax incidence of the sale of inventions reflected in 1943, 1944, or when payment is received?

We believe this will properly be considered a 1944

transaction by the Treasury.

2. Are the payments to Adam properly taken as a deduction in the year when made?

We believe that this payment would not be considered cost but would be entirely deductible in the year when made either as a return of payments previously made under the license contract or incident to the production of income.

3. Is the gain on the sale taxable as a capital gain?

As to the sale of patents there is little question but that the capital gain rate applies.

As to the sale of inventions there is some doubt under recent cases. Nevertheless we feel fairly hopeful that the gain will be taxed as a capital gain.

4. If a substantial part, but less than 30%, of the sales price is paid in 1944, would the profit be taxable as received?

It should be considered an installment sale and only the pro rata part of the profit taxed each year. It would be advisable to provide for payment in installments under a supplemental contract with the Government.

5. What can be capitalized and included in cost of the inventions?

An interesting theory is to consider the cost base of the inventions their value at the time the client became a

resident of this country. This is very doubtful and no support can be found for this view although the question seems never to have been litigated. Apart from this, the actual cost paid in connection with the inventions, including cost of research, cost of materials, compensation paid to others, legal fees and other costs of securing patents, and costs of experimentation should all be considered as part of the cost.

Discussion

1. Is the income tax incidence of the sale of inventions reflected in 1943, or 1944, or when payment is received?

We are hampered here by not being able to see the contract of sale, it being a restricted document. We are to assume that it contained a present assignment.

A contract does not become effective until there has been both execution and delivery. 12 Am. Jur. Contracts #63. In this case there was no delivery of the contract until 1944 so that there is surely no sale in 1943.

Merten's states, in Par. 12.118:

> "Contracts for the sale of property differ so widely according to the nature of the property which is the subject of sale and according to the complexity surrounding the passing of title and terms of payment that it is necessary to use with caution each decision in which the year of profit is determined. The basic question is always to

determine when a sale is made."

The transfer of title and possession, dominion and control are important elements.The mere fact that payment is delayed probably has not prevented the transaction from then becoming taxable.

In Hotel Charlevoix Company vs. Commissioner, 22 BTA 170 (acquiesced X-1 CB 30), it was stated as follows:

> "Under the terms of the agreement entered into in June, 1921, the Realty Mortgage Company also purchased the entire outstanding stock of Hotel Charlevoix Company, including that owned by petitioners Higgins and Jacob. The stock was paid for during 1921, 1922 and 1923. The fact that the purchaser failed to pay the entire purchase price at the time of sale, or even during the year 1921, is of no material significance, however. The sale was completed in June, 1921, and if any tax liability arose it was fixed at that time."

Nevertheless, the question is not wholly clear. If the contract was now supplemented to provide for future payments the supplement might well be recognized. It is believed that a supplement for an installment sale has the best chance.

2. Are the payments to Adam properly taken as a deduction in the year when made?

Prior to 1942, in order to secure a deduction for ordinary and necessary business expenses, it was necessary to show that the expense was incurred in connection with taxpayer's business. In the case of John J. Aurynger, 43 B.T.A. 1208, a government employee who was employed in the munitions building in Washington, had obtained a patent. He brought suit against

the RCA for infringement of the patent and in his income tax return, deducted the amounts he spent in prosecuting the suit. The Commissioner refused to allow the deductions and his ruling was sustained by the Board of Tax Appeals on the ground that the evidence did not show that the payment of legal expenses was in connection with the carrying on of any trade or business within the meaning of the taxing statute. The procurement of the patent and the litigation was a sideline of the taxpayer and the payment was, therefore, held a personal expense.

In the case of Ward v. U. S., 32 Fed. Supp. 743 (D.C. Mass.1940) taxpayer had made a contract with the owner of a patent that he would advance one-half of all expenses in return for which he was to receive 25% of the net profits from the promotion and exploitation of the patent. The holder of the patent became involved in litigation apparently having to do with its patent. One-half of the expenses of the litigation and the amount paid to settle such litigation was paid by taxpayer pursuant to his contract. It was held that the amounts so spent were not a capital investment and could not be amortized over the remaining life of the patent but that they constituted an ordinary business expense. While no mention is made in the opinion of taxpayer's business, it was apparently assumed that the payments were business expenses.

It should be noted here that if we call this payment a business expense we apparently under the theory of the Aurynger

case run some risk under the capital gain statute of having the patents and inventions considered property held primarily for sale to customers. See discussion under Section 3.

Under the 1942 amendment allowing deductions for ordinary and necessary expenses in connection with the production or collection of income or the management, conservation or maintenance of property held for the production of income, taxpayer seems to have a better chance of sustaining the deduction. The case of Raymond M. Hessert, T. C. Memo. Dec. 43187 was decided under this new statute. Taxpayer there owned a certain patent. Apparently this patent had been used by a corporation in which taxpayer held a large amount of stock. This corporation discontinued manufacturing under the patent in 1937, and in 1937 taxpayer entered into a contract with Remington Rand whereby he gave Remington Rand the sole and exclusive right to operate, make, use, sell, rent and put to account the patented machine in return for a certain royalty. This contract was made on the same day on which taxpayer entered into an employment contract with Remington Rand whereby he became sales manager of the division selling the patented machine, though the court did not mention this fact in its opinion. The Tax Court held, however, that taxpayer was entitled to deduct the expenses incurred for legal services in connection with negotiating and drafting the contract between taxpayer and Remington Rand granting the above described rights in the patent to Remington Rand.

In the case of <u>Henry Rose</u> v <u>Commissioner,</u> 1 TC 24

(acq.1943-4-11345) taxpayer held a copyright on a play which he had written. He believed that MGM had infringed the copyright but he had no money to bring suit. His brother agreed to advance him the cost of the suit in return for a promise that he would receive one-half of the amount recovered. After the suit had been brought, it was settled by a compromise payment to the holder of the copyright. He then paid his brother one-half pursuant to the contract. The Tax Court held that this amount was deductible as an ordinary and necessary expense paid in the collection of income.

The argument that the amounts spent to settle the suit are current expenses rather than capital expenditures is sustained by the ruling in 2 CB 105. In that case, the corporation which owned the patent had incurred expenses in certain litigation defending its right, title and interest in such patent. Apparently the company was the plaintiff in the infringement litigation and had sued to protect its rights from infringement by other manufacturers. While it was conceded that amounts spent prior to the issuance of the patent for filing fees, attorneys' fees, etc. were part of the cost of the patent, it was concluded that amounts spent after the issuance of the patent in infringement litigation were deductible as ordinary and necessary operating expenses since they added no value to the patent owned and did not prolong the life of the property and did not improve it in any way. In S.M. 2423, III-2 C.B. 157, the above ruling was construed as being based on regulations defining what con-

stitutes the cost of a patent. The regulation then was almost exactly the same as the present Reg. 111, Sec. 29.23 (1)-7.

Another theory which permits deduction is that the payment in 1943 was a repayment of amounts received under the 1936 license agreement. Those amounts would have constituted taxable income to client if he had then been a resident of the United States. Repayment would then constitute a deduction.

Taxpayer was a director of the M Company. To assist the company, he and some other persons acquired stock in the N Company. In 1928 and 1929, taxpayer made large profits dealing in the shares of the N Company. He returned these profits as income in his tax returns for those years.

Subsequently, the M Company went into bankruptcy and taxpayer was compelled to account to the trustee for the profits realized from his dealings in the N Company stock.

Taxpayer contended that his 1928 and 1929 returns should be revised so as to eliminate the profits from income in those years. The General Counsel ruled that the profits had been properly included in income in 1928 and 1929 "but that the taxpayer is entitled to a deduction for the year in which paid of the amount of the profits paid to the trustee for the M Company." XV-1 C.B. 179.

Is the gain on the sale taxable
as a capital gain?

Under the income tax law as it existed in 1943 and in 1944, capital assets included any kind of property, except:

(1) Stock in trade properly included in inventory

(2) Property for sale to customers in the ordinary course of trade or business.

(3) Property used in trade or business of a character subject to allowance for depreciation.

(4) Other property not pertinent to the discussion.

Under Section 117-(j) any gain from sale of property used in trade or business of a character which is subject to the allowance for depreciation and held for more than six months is taxed as a capital gain.

The recent Goldsmith case hinged on the distinction made by the above exceptions. Clifford H. Goldsmith transferred to Paramount Pictures the world-wide motion picture rights and other related rights in and to the plays entitled "Enter to Learn" and "What a Life." The Tax Court held that this was not a capital gain for two reasons:

1. That a license rather than a sale was involved.

2. Under the 1938 Act, (which was applicable to this transaction) property used in a trade or business of a character subject to allowance for depreciation was not subject to the capital gain or loss provisions. The Tax Court considered a copyright property of this kind.

On appeal to the Second Circuit, one judge held that there was no sale. The remainder of the court held that it was not a capital gain because of another exception from the capital gain

provisions of the 1938 Act, namely that it was property which constituted inventory in the business of Clifford Goldsmith, his business being that of playwright.

It should be noted that since 1938 Clifford Goldsmith has been writing "The Aldrich Family" and the Tax Court found as a fact that "petitioner earned his livelihood in 1938 and 1939 as author and playwright and his trade or business was that of author and playwright and the copyright in question was used in his trade or business during both taxable years." Goldsmith v. Commissioner, 1 T.C. 711; 143 Fed. (2d) 466.

In Hogg v. Commissioner, Mem. Op., Doc. 112,504, it was held that where a taxpayer had regular employment and spent but four hours a week on inventions and developed over a period of twenty years four patents of which he had sold one, the patent sold did not constitute inventory held in the ordinary course of his business or property used in his trade or business subject to allowance for depreciation. The result was that a capital gain was allowed upon the sale of the patent.

In Diescher v. Commissioner, 36 B.T.A. 732 (Acq. 1938-1 C.B. 9), there was a sale of patents. A partnership had developed and owned other patents which it had licensed others to use but the sale involved was the only sale

of patents that was made. The Commissioner contended that the patents were held by the partnership primarily for sale in the course of its business, but the Board held that this contention had no merit.

As we understand the facts, client developed his inventions chiefly while engaged in educational work in foreign universities; that since arriving in this country - first at Columbia University and now at the University of Chicago, he has been engaged in making further developments along the lines of the inventions.

The Goldsmith case was decided under the 1938 Act. The 1942 Act provides (Section 117 (j)) that gain from property used in a trade or business of a character which is subject to allowance for depreciation sold at a gain is subject to the capital gain rate. Under the 1938 Act, this was not so and as we have previously noted, the Tax Court expressly held a copyright to be this kind of property.

As to the patents sold in 1943, it would seem that the capital gain rate should be allowed because:

(a) There was a sale, and

(b) If it is property used in business, it is property subject to depreciation and thus within Section 117 (j) above mentioned.

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As to the inventions, there was apparently an absolute sale. However, we are subject to two arguments:

1. ~~The inventions were property which constituted stock in trade because the sale of these inventions to the Government apparently was a condition of his employment in further research and research in this field was his sole occupation at the time of sale. Apparently the theory of the Second Circuit in the Goldsmith case is that the situation in the year of sale determines whether the copyright is stock in trade.~~ no

2. In no event would the inventions constitute property used in a business subject to depreciation because inventions are not subject to depreciation. (See CCH 221.001.)

The chances are that the Commissioner will initially treat the sales as ordinary income but on a contest, client should have something better than a fifty per cent chance. If he did not want to litigate, he would still have the chance of favorable compromise.

A further question here is whether the property sold had been held for more than six months. In the case of the patent sold in 1943, the patent had been issued for more than six months and there is no question. In the case of the inventions there had been no patents is-

sued and Diescher v. Commissioner, 36 B.T.A. 732 (Acq. 1938-1 C.B. 9) seems to have settled the law to the effect that in the case of inventions the time of holding begins to run from the date the inventions were reduced to practice. It appears from the facts here that the reduction to practice occurred not later than 1941.

4. If a substantial part, but less than 30%, of the sales price is paid in 1944, will the profit be taxable as received?

Section 44 of the Internal Revenue Code provides in the case of a casual sale or other casual disposition of property (other than 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) for a price exceeding $1,000, if the initial payments do not exceed 30% of the selling price, the income may be returned on the installment basis - that is, the taxpayer will return each year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed bears to the total contract price.

Unless there is an initial payment under the con-

tract, this provision does not apply. (CCH 1944, Par. 421.01.)

The Government might make two contentions against the right to return the profit on this basis:

1. There was nothing paid down at the time the contract was delivered. It would seem, however, that the initial payment under this contract should relate back to the time of delivery of the contract as the contract did not call for any deferment of the entire purchase price.

2. Under the theory of the Goldsmith case, the inventions are property of a kind which would properly be included in the inventory. This point has its dangers but as noted under Point 3, it is difficult to consider these inventions as being in client's inventory.

5. What can be capitalized and included in the cost of inventions?

The Internal Revenue Code provides for a tax on individuals. (Sec. 11 and Sec. 12, I.R.C.) Regulations 111, Sec. 29.11 (2) states:

> "Citizens or Residents of the United States Liable to Tax.- In general, citizens of the United States, wherever resident, are liable to the tax, and it makes no difference that they may own no assets within the United States and may receive no income from sources within the United States. Every resident alien individual is liable to the tax, even though his income is wholly from sources outside the United States. As to nonresident alien individuals, see sections 211 to 219, inclusive."

In respect of nonresident individuals, income from the sale of patents and inventions developed in a foreign country would be apportioned between the United States and the foreign country and only that part apportioned to the United States would be taxable. (Sec. 119 and Sec. 211, I.R.C.)

The income from the sale of inventions and patents is, of course, the gross proceeds less the cost. It would seem that the cost would constitute only the actual expenses in developing and prosecuting the inventions and patents. It would be fairer if the cost was considered the cost base of the assets when the client became a resident of the United States. Possibly an argument could be made that that is all the United States can constitutionally tax. However, we find no cases in which the point is raised. It is not a point that one would risk an entire case on, but if the matter ever got into litigation, it is possibly a point that should be raised.

Cost necessarily includes all expenses incurred by client in connection with development of the inventions. No deductions have been taken by him as current expense for any such cost and they all should be capitalized. (Reg. 111, Sec. 29.23 (1)-7.)