10 T.C. 974 (1948)

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For excess profits tax calculations, the amount of money paid in for stock is the net amount received by the corporation after deducting underwriting commissions, and a license to manufacture and sell patented products does not constitute a sale for capital gains purposes.

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Summary

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Cleveland Graphite Bronze Co. disputed deficiencies in excess profits taxes for 1941 and 1942. The Tax Court addressed four issues: (1) whether the "daily capital addition" from selling preferred stock should be reduced by underwriting commissions; (2) whether daily capital reduction from stock retirement should be based on par value or repurchase price; (3) whether royalty income from British patents was ordinary income or capital gains; and (4) whether a credit could be claimed for British taxes withheld from royalties. The Tax Court held against the taxpayer on all issues except the second, determining that capital reduction should be based on the actual repurchase price of the shares. The key finding was that the agreement with Vandervell Products Ltd. constituted a license, not a sale, of British patents.

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Facts

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- In 1941, Cleveland Graphite Bronze Co. entered into an agreement with underwriters to sell 30,000 shares of newly authorized preferred stock at $100 per share, paying the underwriters a commission of $3.50 per share.

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- In 1942, the company retired 680 and 364 shares of its preferred stock, purchasing them back from holders.

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- In 1938, Cleveland Graphite Bronze Co. executed an agreement with Vandervell Products Ltd. (British company) concerning British patents.

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- Vandervell Products Ltd. retained certain amounts from royalty payments as British taxes.

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Procedural History

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The Commissioner of Internal Revenue determined deficiencies in Cleveland Graphite Bronze Co.'s excess profits taxes for 1941 and 1942. The company petitioned the Tax Court, claiming overpayment of taxes and contesting the Commissioner's calculations of daily capital additions and reductions, the characterization of royalty income, and the denial of a tax credit for British taxes withheld.

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Issue(s)

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1. Whether the "daily capital addition" resulting from the sale of preferred stock in 1941 is the gross amount received from underwriters ($3,000,000) or that amount less the commission paid to the underwriters?

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2. Whether the "daily capital reduction" resulting from the retirement of preferred stock in 1942 is the par value of the stock or the amounts paid to repurchase the stock?

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3. Whether royalties received from Vandervell Products Ltd. are ordinary income or long-term capital gains?

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4. Whether Cleveland Graphite Bronze Co. is entitled to a credit against tax under section 131 (a) (1), Internal Revenue Code, for royalties retained by Vandervell Products Ltd. as British taxes?

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Holding

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1. No, because the amount of money paid in for stock is the net amount received by the company after deducting underwriting commissions.

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2. Yes, because the daily capital reduction should reflect the actual economic outlay by the company to retire the stock.

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3. No, because the agreement constituted a license, not a sale, of the British patents, as it did not transfer all substantial rights.

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4. No, because the British tax was levied upon and paid by the British company, not the taxpayer.

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Court’s Reasoning

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The court reasoned that the “daily capital addition” should reflect the net amount the company actually received. While acknowledging cases where funds from public investors passed through underwriters, the court found insufficient evidence that

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the stock was actually sold to the public. As such, it was appropriate for the Commissioner to reduce the amount received by the commission paid to the underwriters.

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Regarding the capital reduction, the court, agreeing with the Commissioner's concession, determined that the amounts actually paid by the company for the stock should be used in the calculation. This aligns with the economic reality of the transaction.

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On the patent issue, the court emphasized that the agreement with Vandervell Products Ltd. was merely a license, not a sale of the British patents. Quoting Waterman v. Mackenzie, <span normalizedcite="138 U.S. 252“>138 U.S. 252, the court stated, "Any assignment or transfer, short of one of these is a mere license, giving the licensee no title in the patent, and no right to sue at law in his own name for an infringement." Because the agreement did not transfer all substantial rights, particularly the right to use the patented products, it was a license, and the royalty income was ordinary income, not capital gains.

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Finally, the court followed Irving Air Chute Co., 1 T.C. 880, holding that the British taxes were levied on the British company, not the taxpayer, so no credit was allowed.

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Practical Implications

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This case clarifies how to calculate

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