***Leech v. Commissioner, T.C. Memo. 1955-3***

Payments received by an employee from their employer for inventions developed during the course of employment, where the employment agreement stipulates assignment of patents to the employer, are considered compensation for services and taxable as ordinary income, not capital gains from the sale of assets.

**Summary**

The petitioner, an employee, received payments from his employer based on a contract stipulating that any patents developed during his employment related to chain saws would be assigned to the company. The Tax Court addressed whether these payments should be taxed as ordinary income (compensation) or capital gains (sale of patents). The court held that because the employment agreements clearly indicated that inventions and patents developed were the property of the company, and the payments were compensation under the employment contract, the income was taxable as ordinary income, not capital gains from the sale of capital assets. The court also addressed and partially allowed deductions for legal and travel expenses.

**Facts**

The petitioner was employed by a company under several interrelated agreements. These agreements specified his role in developing a power chain saw and explicitly stated that any patents arising from his work on chain saws would be assigned to the company. The petitioner worked at the company's plant, using their facilities and assistance. He had previously assigned other patents to the company without additional compensation, suggesting an understanding of his contractual obligations. The patents in question were developed and applied for during his employment, although some were granted after his employment ended. The petitioner received commission-based payments related to the Mafell-type power chain saws, which were the subject of the patent agreements.

**Procedural History**

The Commissioner of Internal Revenue determined that payments made to the petitioner were compensation taxable as ordinary income. The petitioner contested this determination in Tax Court, arguing the payments were capital gains from the sale of patents or from the sale of his interest in a joint venture. The Tax Court reviewed the Commissioner's determination.

**Issue(s)**

1. Whether payments received by the petitioner from the company for inventions related to chain saws, developed during his employment and assigned to the company per their agreement, constitute compensation taxable as ordinary income or capital gains from the sale of capital assets.

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2. Whether the petitioner was entitled to deduct legal fees and travel expenses incurred in connection with his employment contract in the taxable year 1943.

3. Whether the petitioner was entitled to deduct an expenditure of $1,861.33 in the taxable year 1944 as a cost related to the assignment of patents.

**Holding**

1. No, because the employment agreements clearly stipulated that patents developed during employment were the property of the company, and the payments were compensation for services under the employment contract, not consideration for the sale of patents.

2. Yes, because the petitioner's testimony established a prima facie case for deductible legal fees and travel expenses in 1943, which the Commissioner did not effectively rebut.

3. No, because the court had already determined that the patents were the exclusive property of the company and there was no sale of patents by the petitioner; therefore, there was no basis for deducting costs associated with a non-existent sale.

**Court's Reasoning**

The court reasoned that the employment agreements were unambiguous and clearly indicated that any inventions related to chain saws developed by the petitioner during his employment were intended to be the property of the company. The court cited *Standard Parts Co. v. Peck*, 264 U.S. 52, emphasizing that when an employee is hired to devote their time to developing a specific product, the resulting invention belongs to the employer. The court highlighted a clause in the 1939 agreement stating, "Should any patents be granted on any of these claims you agree that these will be assigned forthwith to this Company, without any other compensation to you than that provided under this agreement." This clause, along with the petitioner's conduct of previously assigning patents, demonstrated a clear understanding that the inventions were the company's property. The court dismissed the petitioner's argument about the terminable nature of the contract as irrelevant to the ownership of inventions made during employment. Regarding deductions, the court accepted the petitioner's testimony for legal and travel expenses in 1943 but denied the 1944 deduction related to patent assignment because no sale of patents by the petitioner occurred.

**Practical Implications**

This case reinforces the principle that employment agreements dictating the ownership of employee inventions are generally enforceable. It clarifies that payments made to employees pursuant to such agreements for inventions developed within the scope of their employment are considered compensation for services and are taxed as ordinary income. For legal practitioners, this case serves as a reminder

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of the importance of clearly drafted employment agreements regarding intellectual property rights. For businesses, it confirms their right to ownership of inventions created by employees when the employment contract explicitly provides for such ownership. This decision has been consistently applied in subsequent cases to determine the tax treatment of payments related to employee inventions, emphasizing the contractual terms defining the relationship between employer and employee regarding intellectual property.

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