11 T.C. 153 (1948)

An oral agreement to assign a portion of an invention to a party who provides valuable services in its development can create an enforceable equitable ownership interest, and royalty income from the sale of the invention can qualify for capital gains treatment if the invention is a capital asset and the sale constitutes a closed transaction.

Summary

Carl Dreymann orally promised his daughter, Annie, a one-half interest in a moisture-proofing paper process if she helped him develop it. Annie provided substantial services from 1932 to 1942. The Tax Court held that Annie acquired a one-half equitable interest when the process was reduced to practice, therefore, half the royalty income was not includible in Carl's gross income. The court also determined that Carl's gain from the sale of the invention qualified for capital gains treatment under Section 117 of the Internal Revenue Code, as the assignment of the patent was a closed transaction and the invention was a capital asset not held primarily for sale in the ordinary course of business.

Facts

Carl Dreymann, seeking to develop a moisture-proofing process for paper, promised his daughter Annie a one-half interest in the process if she assisted him. Annie, with a scientific background, agreed and provided substantial services from September 1932, including conducting tests, keeping records, and helping develop manufacturing methods. In April 1933, Carl contracted with Grant Paper Box Co. to develop the formula. By August 1933, a viable process was discovered and a new contract was made to give Grant exclusive manufacturing rights. Under the August 30, 1933 agreement, Grant would pay royalties, half to Carl and half to Annie.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Carl Dreymann's income taxes for 1941, 1943, and 1944, arguing that all royalty income was includible in Carl's gross income and taxable as ordinary income. Dreymann petitioned the Tax Court, arguing that half the royalty income belonged to Annie and that the income qualified for capital gains treatment.

Issue(s)

1. Is all of the royalty income realized from the sale of the moisture-proofing process includible in Carl Dreymann's gross income?
2. Is the royalty income realized by Dreymann from the sale of the invention taxable as ordinary income or as capital gain?

Holding

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1. No, because Annie acquired a one-half equitable interest in the moisture-proofing process due to the oral agreement and her substantial contributions, making half of the royalty income attributable to her property interest.
2. Capital gain, because the assignment of the patent constituted a sale of a capital asset, and the taxpayer did not hold the invention primarily for sale to customers in the ordinary course of his trade or business.

Court's Reasoning

The Tax Court reasoned that the oral agreement between Carl and Annie, coupled with Annie's substantial services, created an enforceable equitable interest in the invention for Annie. The court distinguished this from assigning future earnings, as in *Lucas v. Earl* and *Helvering v. Horst*, because Annie received a property interest in the invention itself. As to whether the royalty income qualifies as capital gains, the court found that the August 30, 1933, contract was an executory contract, and the sale occurred with the patent assignment on August 22, 1935. The court cited *Kimble Glass Co.* and *Commissioner v. Celanese Corporation*, stating the term "royalty" was a misnomer and the payments constituted the purchase price of the invention. Furthermore, the court determined Carl was not in the business of selling inventions, distinguishing this case from cases like *Harold T. Avery*. Ultimately, the court determined that 66 2/3% of the gain should be considered when computing net income for 1941 and 50% for 1942-1944.

Practical Implications

Dreymann v. Commissioner clarifies that oral agreements to assign inventions, when supported by consideration in the form of substantial services, can create enforceable equitable ownership interests for tax purposes. This case highlights the importance of documenting intellectual property agreements, especially within families. For tax planning, it establishes that periodic payments for the sale of a capital asset, such as a patent, can still qualify for capital gains treatment. Later cases applying *Dreymann* emphasize the need to demonstrate a clear intent to transfer ownership and the provision of valuable consideration for such a transfer to be recognized for tax purposes.

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