14 T.C. 1056 (1950)

Payments received for the exclusive privilege or license to manufacture certain styles and designs of goods, measured by the quantity produced, constitute royalties for personal holding company income purposes, even if some services are also provided.

Summary

Warren Browne, Inc. contracted with Australian shoe manufacturers, granting them the exclusive right to manufacture shoes based on American designs. The IRS determined that the income derived from these contracts constituted royalties, making Warren Browne, Inc. a personal holding company subject to surtax. The Tax Court upheld the IRS determination, finding that the principal value transferred was the exclusive license to manufacture particular shoe styles, not the ancillary services provided in connection with those licenses. This case clarifies the definition of 'royalties' in the context of personal holding company income.

Facts

Warren Browne, Inc. (Petitioner) entered into contracts with several Australian shoe manufacturers. These contracts allowed the Australian companies to exclusively manufacture shoes in Australia and New Zealand using designs sourced from American shoe companies. Petitioner received payments ranging from 7 to 50 cents per pair of shoes manufactured by the Australian companies. Petitioner obtained these designs through agreements with American firms like Dixon-Bartlett Co., Samuels Shoe Co., and Packard Shoe Co. Petitioner's activities involved facilitating access to American shoe manufacturing techniques and providing sample shoes and materials.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in personal holding company surtax against the Petitioner for the fiscal years ended August 31, 1945, and August 31, 1946. The Petitioner challenged this determination in the Tax Court, arguing that its income was derived from services, not royalties.

Issue(s)

1. Whether the income received by Petitioner under contracts with Australian shoe manufacturers constitutes personal holding company income under Section 502(a) of the Internal Revenue Code?
2. Specifically, whether the payments received by Petitioner are considered royalties, as opposed to compensation for services rendered?

Holding

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1. Yes, because at least 80% of the Petitioner's gross income was derived from royalties.
2. Yes, because the principal value transferred was the exclusive license to manufacture particular shoe styles, and the payments were proportionate to use.

Court's Reasoning

The court reasoned that the term "royalties" includes amounts received for the privilege of using patents, copyrights, secret processes, and "other like property." The court cited *United States Universal Joints Co., 46 B.T.A. 111, 116*, defining the term as a payment or interest reserved by an owner for permission to use the property loaned. The court acknowledged that some services were provided by the Petitioner, such as arranging for Australian manufacturers to visit American factories and providing sample materials. However, the court emphasized that "what the Australian manufacturers wanted was the exclusive privilege or license to manufacture certain styles and designs of American shoes in the territory comprising Australia and New Zealand." The court distinguished this case from *Lane-Wells Co., 43 B.T.A. 463*, where the taxpayer failed to present evidence showing what part, if any, of payments received was for engineering services. The court found that the Petitioner had not proven that more than 20% of the payments it received should be allocated to services, nor had it proven that at least 80% of these payments should not be allocated to the use of the exclusive privilege to manufacture certain shoe styles.

Practical Implications

This case provides guidance on distinguishing between royalty income and service income in the context of personal holding companies. It highlights that the substance of the agreement, rather than its form, controls the determination. Attorneys should carefully analyze the nature of the rights granted under licensing agreements. If the primary benefit conferred is the exclusive right to use a particular design or process, and the payments are proportionate to use, the income is likely to be treated as royalties. Taxpayers should maintain detailed records to allocate income between royalties and services if they wish to avoid personal holding company status. The case reinforces the principle that payments measured by production quantities are indicative of royalty income when an exclusive right to use property is conveyed.

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