T.C. Memo. 1951-9

When a patent owner transfers all substantial rights in a patent to another party, the payments received, even if termed “royalties,” are treated as proceeds from the sale of a capital asset and qualify for capital gains treatment rather than ordinary income.

Summary

Thompson transferred his patent rights to a corporation in exchange for payments contingent on the corporation’s sales, termed “royalties.” The IRS argued these payments were ordinary income (royalties), while Thompson argued they were capital gains from the sale of a capital asset. The Tax Court held that because Thompson transferred all substantial rights in the patents, the payments were properly characterized as installment payments from a sale, taxable as capital gains. This case clarifies that the substance of the transaction—transfer of ownership—controls over the form (labeling payments as royalties).

Facts

- Thompson owned patents and inventions related to drinking fountains and water cooling equipment.
- A 1926 agreement granted a corporation a non-exclusive license to use Thompson’s inventions, with royalty payments to Thompson.
- In 1945, Thompson and the corporation entered a new agreement where Thompson assigned his patents to the corporation.
- The assignments stipulated that the corporation would continue to pay Thompson royalties as specified in the 1926 agreement.
- Thompson received $100,220.44 from the corporation in 1947 under this arrangement.

Procedural History

The Commissioner of Internal Revenue determined that the payments Thompson received were taxable as ordinary income. Thompson challenged this determination in the Tax Court, arguing the payments constituted long-term capital gains.

Issue(s)

Whether payments received by Thompson from the corporation in 1947 for the transfer of patent rights constitute royalties taxable as ordinary income, or proceeds from the sale of capital assets taxable as capital gains?

Holding

Yes, the payments constituted proceeds from the sale of capital assets taxable as capital gains because Thompson transferred all substantial rights in the patents to the corporation.

Court's Reasoning

- The court emphasized that the substance of the transaction, viewed as a whole, determines the character of the income, not just the form of the agreements.
- Although the 1945 agreement didn't use the word "sale," it provided for the assignment of patents. The assignments themselves transferred Thompson's entire right, title, and interest in the patents.
- The court found the continued payments, though termed "royalties," were the real consideration for the assignments.
- The court distinguished a sale from a license, stating that when the owner of a patent transfers their entire interest in the patent, it's a sale, regardless of whether the instrument is called a license or the consideration is called a royalty. The court cited *Edward G. Myers, 6 T.C. 258* and *Carl G. Dreymann, 11 T.C. 153*.
- The court stated, "Prior to the agreement of February 7, 1945, and the assignments of May 22, 1945, the letters patent and an invention were owned by petitioner who was entitled to royalties from his nonexclusive licensee, but thereafter the corporation was the absolute owner thereof and perforce the petitioner was no longer a licensor. Accordingly, the continued payments which the corporation was obligated to make to petitioner as a 'condition' for its acquisition of the patents and invention must be deemed to be the purchase price thereof."

Practical Implications

- This case provides guidance on distinguishing between a sale of patent rights (resulting in capital gains) and a mere license (resulting in ordinary income).
- The key factor is whether the patent holder transferred all substantial rights in the patent. If so, the transaction is more likely to be considered a sale, even if payments are structured like royalties.
- Legal practitioners should carefully examine the agreements and surrounding circumstances to determine the true intent of the parties. The labels used in the agreements are not determinative.
- This ruling has implications for tax planning, as capital gains are typically taxed at a lower rate than ordinary income.
- Later cases citing Thompson often focus on the "all substantial rights" test to determine whether a patent transfer constitutes a sale or a license.

