18 T.C. 291 (1952)

A transfer of patent rights constitutes a sale, resulting in capital gains treatment, only if the transfer conveys the exclusive right to make, use, and vend the invention throughout the United States; anything less is a license, and payments received are taxed as ordinary income.

Summary

The Tax Court addressed whether payments received by the Greggs for granting rights to manufacture and sell their rope sole patent constituted ordinary income or capital gains. The Greggs granted a company the "sole and exclusive right and license to manufacture and sell" their patented rope soles. The court held that this arrangement was a license, not a sale, because the Greggs retained significant control over the patent, including the right to make other arrangements if demand exceeded the licensee's capacity. Therefore, the payments were taxable as ordinary income. The court also addressed deductions claimed for compensation and a loss on materials.

Facts

The Greggs developed a method for manufacturing rope soles and obtained a patent application. Lynne Gregg assigned the application to her wife, Lynne Gregg. The Greggs entered into an agreement with Norwalk Co. granting the "sole and exclusive right and license to manufacture and sell" the rope sole product in the United States. This agreement was later extended to Panther-Panco Rubber Company, Inc. The Greggs received income under these agreements. They also claimed deductions for compensation paid to the petitioner's brother and for a loss on plasto-cloth material.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Greggs' income tax for the years 1942, 1943, and 1944. The Greggs petitioned the Tax Court for a redetermination of these deficiencies. The Tax Court consolidated the cases for trial.

Issue(s)

1. Whether the payments received by the Greggs from Norwalk Co. and Panther-Panco under the agreement and its extension constituted ordinary income or capital gains from the sale of a patent.
2. Whether the petitioner was entitled to deduct $10,000 from his gross income for the taxable year 1943 as compensation to his brother for services rendered in connection with the patent.
3. Whether the petitioner was entitled to a loss deduction in 1944 for a loss sustained on certain plasto-cloth material.

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Holding

1. No, because the agreement constituted a license rather than a sale, as the Greggs retained significant rights and control over the patent.
2. No, but a partial deduction of $1,300 is allowable because the evidence supported that amount as reasonable compensation.
3. No, because the loss was sustained in 1945 when the material was sold, and the Commissioner correctly allowed the deduction in that year.

Court's Reasoning

The court relied on *Waterman v. Mackenzie, 138 U.S. 252*, which established that the transfer of a patent constitutes an assignment or sale only if it conveys: "(1) the exclusive right to make, use and vend the invention throughout the United States, or, (2) an undivided part or share of that exclusive right, or (3) the exclusive right under the patent within and through a specific part of the United States." Because the Greggs retained certain rights, such as the ability to make other arrangements if demand exceeded Norwalk's capacity, the court concluded that the agreement was a license, not a sale. The court also found that the evidence did not fully support the claimed $10,000 deduction for compensation, but applied the rule of *Cohan v. Commissioner, 39 F.2d 540*, to allow a partial deduction of $1,300 based on the available evidence. Finally, the court determined that the loss on the plasto-cloth material was sustained in 1945, when the material was sold, and the deduction was properly allowed in that year.

Practical Implications

This case clarifies the distinction between a sale and a license of patent rights for tax purposes. Attorneys drafting patent agreements must carefully consider the specific rights transferred and retained by the parties to ensure the desired tax treatment. Retaining significant control or conditional rights over the patent will likely result in the agreement being classified as a license, with payments taxed as ordinary income. Subsequent cases have cited *Gregg* to emphasize the importance of examining the substance of the agreement over its form when determining whether a patent transfer constitutes a sale or a license. Agreements labeled as licenses can be treated as sales, and vice versa, based on the rights actually conveyed. This case also demonstrates the importance of providing sufficient evidence to support claimed deductions, and it illustrates the application of the *Cohan* rule when precise documentation is lacking.

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