23 T.C. 775 (1955)

A transfer of copyright rights that retains significant control over the exploitation of the copyrighted work and is compensated by royalties is considered a license, not a sale, for federal income tax purposes, even if the rights are exclusive.

Summary

Daniel M. Cory received a gift of the copyright to George Santayana's autobiography, "Persons and Places." Cory then entered into an agreement with Charles Scribner's Sons for its publication. The IRS determined that the income Cory received from the agreement was taxable as ordinary income, not capital gains. The Tax Court agreed, holding that the agreement with Scribner's was a license, not a sale. The court reasoned that Cory retained significant control over the exploitation of the copyright through the agreement, and his compensation was tied to royalties based on sales, which is characteristic of a license. This determination had implications for how the income derived from the book's publication should be taxed.

Facts

Daniel M. Cory, a scholar and friend of philosopher George Santayana, received a gift of the manuscript of Santayana's autobiography, "Persons and Places." Cory subsequently entered into a publication agreement with Charles Scribner's Sons, granting them the exclusive right to publish the work in the United States and Canada. The agreement provided for Cory to receive royalties based on sales. However, the agreement did not convey all rights to the manuscript, as Cory retained serial rights and the right to publish in other territories and media. The IRS contended that the income from the publication agreement was ordinary income, while Cory argued it was capital gain from the sale of a capital asset.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Cory's income tax for 1944, asserting the income from the publication of "Persons and Places" was ordinary income, not capital gains. Cory claimed an overpayment of taxes, arguing the income should be treated as capital gain. The case was brought before the United States Tax Court, which ruled in favor of the Commissioner.

Issue(s)

1. Whether the agreement between Cory and Scribner's Sons constituted a sale or a license of the copyright for tax purposes.
2. If the agreement was a license, whether the income received by Cory from the publication should be taxed as ordinary income or capital gains.
3. What was the correct amount of income Cory realized in 1944 from the publication agreement with Scribner's?

Holding

1. No, because Cory retained significant control over the exploitation of the copyrighted work and the compensation was based on royalties.
2. Yes, because since the agreement was a license, not a sale, the income received by Cory was ordinary income.
3. The correct amount of income to Cory in 1944 was $12,000.

Court's Reasoning

The court distinguished between a sale and a license of a copyright. A sale involves transferring all substantial rights in the property, while a license grants limited rights while retaining ownership. The Tax Court found that the agreement between Cory and Scribner's Sons was a license because Cory did not transfer all his rights. He retained rights to the serial publication of the work, the right to publish in other territories, and the rights to exploit the work in other media (such as motion pictures). Crucially, Cory's compensation was based on royalties tied to sales. The court cited prior cases to support the distinction, emphasizing that the transfer of all substantial rights and the nature of the compensation are key factors. The court noted: "In our opinion, essential elements of a sale were lacking, and we conclude and hold that the transaction between petitioner and Scribner's for the publication of 'Persons and Places' was a license, not a sale." Because the agreement was deemed a license, the court held that the income was ordinary income. The Court also decided that, despite the total royalties earned, Cory's income for 1944 was limited to the $12,000 that he was entitled to draw down that year under a tripartite agreement.

Practical Implications

This case emphasizes the importance of carefully drafting agreements involving copyrighted works to achieve the desired tax treatment. If the goal is to treat the transfer as a sale for capital gains purposes, the agreement must transfer all substantial rights in the copyright. Retaining any significant rights, such as serial rights, translation rights, or the right to exploit the work in other media, may result in the agreement being treated as a license, with income taxed as ordinary income. The nature of the compensation is also critical. A lump-sum payment might support a sale classification, while royalties tied to sales or profits are indicative of a license. This case should influence the structuring of contracts involving the transfer of intellectual property rights. Subsequent rulings, and changes in the Internal Revenue Code, may modify some of the specifics, but the underlying distinction between a sale and a license remains relevant.

