*25 T.C. 481 (1955)*

To qualify as a sale of a patent, the agreement must transfer all substantial rights of the patentee, including the right to make, use, and sell the invention.

**Summary**

The United States Tax Court addressed whether payments received by a partnership from a licensing agreement for patent rights constituted long-term capital gain from a sale or ordinary income from royalties. The court found that because the agreement did not transfer all substantial rights of the patentee, it was a license, and the payments were ordinary income. The court also determined the basis for depreciation of patents, allowing depreciation based on the cost of machinery and payments for patent acquisition, despite the loss of original records. The case underscores the importance of transferring all patent rights, specifically the right to make, use, and vend, to achieve capital gains treatment for tax purposes.

**Facts**

The Rollmans, a partnership, owned the Rajeh patent for a rubber footwear process. The partnership entered into an agreement with Rikol, Inc., granting Rikol an "exclusive license" to manufacture and sell shoes under the patent. The agreement also granted Rikol the right to sublicense to corporations controlled by Leo Weill but did not include the right to use the process. Rikol subsequently entered into a sublicense agreement with Wellco Shoe Corporation, also controlled by Leo Weill. The Rollmans received payments from Wellco in 1947, 1948, and 1949. The Rollmans claimed these payments as long-term capital gains on their tax returns. Additionally, the Rollmans sought depreciation deductions on the Rajeh patent, as well as on two other patents, Paraflex and Snow Boot.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in the Rollmans' federal income taxes for 1947, 1948, and 1949, reclassifying the payments from Rikol as ordinary income. The Commissioner also disallowed the depreciation deductions claimed by the Rollmans. The Rollmans petitioned the United States Tax Court, challenging the reclassification of income and the disallowance of depreciation deductions. The Tax Court consolidated the cases of the Rollman partners.

**Issue(s)**

1. Whether payments received by The Rollmans from Rikol pursuant to a written agreement in respect to patent rights constitute long-term capital gain from the sale of a capital asset or ordinary income (royalties) from a licensing agreement.

2. To what extent, if any, the partnership is entitled to a deduction for depreciation

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on the Rajeh, Paraflex, and Snow Boot patents.

**Holding**

1. No, because the agreement only granted an exclusive license to manufacture and sell, not the right to use, the payments are considered ordinary income (royalties), not capital gains.

2. Yes, a depreciation deduction is allowed on the Rajeh and Paraflex patents, but the claimed depreciation on the Snow Boot patent was disallowed as it exceeded its established basis.

**Court's Reasoning**

The court focused on whether the agreement between the Rollmans and Rikol constituted a sale or a license of the Rajeh patent. The court relied on the Supreme Court case, *Waterman v. MacKenzie*, which established that a transfer must include the exclusive right to make, use, and vend to be considered a sale. The agreement in this case only granted the right to manufacture and sell, not to use, the patented process. Because Rikol couldn't permit others to use the process, the court held that all substantial rights were not transferred, and the agreement was a license. The court emphasized, "the agreement must effect a transfer of all of the substantial rights of the patentee under the patent in order to constitute a sale for Federal income tax purposes."

Concerning depreciation, the court found sufficient evidence to establish a basis for the Rajeh and Paraflex patents, despite the loss of the partnership's original records. The court applied the *Cohan* rule, allowing a reasonable estimate of costs. However, since they had previously recovered an amount in excess of their basis, the court denied any additional depreciation allowance for the Snow Boot patent.

**Practical Implications**

This case is critical for tax planning involving intellectual property. It highlights that, for tax purposes, the characterization of a patent transfer as a sale or a license depends on the *legal effect* of the agreement, not its name. Attorneys should carefully draft patent transfer agreements to ensure that they convey all substantial rights, including the right to make, use, and sell, to qualify for capital gains treatment. Failing to do so will result in ordinary income treatment. The court's decision provides a clear precedent for distinguishing between patent sales and licenses, especially when drafting or interpreting such agreements. It also reminds practitioners that, even with incomplete records, courts may allow a reasonable estimate of basis under certain circumstances. The decision also underscores the importance of accurately accounting for prior depreciation deductions.

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