Marco v. Commissioner, 25 T.C. 544 (T.C. 1955)

The transfer of exclusive rights to manufacture, use, and sell a patented invention for its entire life constitutes a sale of patent rights, the proceeds of which are taxable as capital gains, not ordinary income from a license.

Summary

Vincent Marco, a patent holder, granted exclusive rights to manufacture, use, and sell his patented indicator lights to two companies in different territories. Initially, agreements were for 5-year licenses, and income was treated as ordinary royalty income. Later, agreements were modified to extend for the life of the patents and include the right to 'use' the invention. The Tax Court addressed whether payments received under these extended agreements constituted proceeds from a sale of patent rights (capital gains) or royalties from a license (ordinary income). The court held that granting exclusive rights for the patents' lifetime, including the right to 'use,' constituted a sale, thus qualifying the income for capital gains treatment.

Facts

Vincent Marco invented an indicator light and obtained patents in 1947.

In 1944, Marco granted Signal Indicator Corporation exclusive rights to manufacture, sell, and distribute the lights east of the Mississippi for 5 years, receiving 10% of gross sales as royalties. This was treated as ordinary income.

Also in 1944, Marco granted Searle Aero Industries similar rights west of the Mississippi for 5 years, receiving 9% royalties, also treated as ordinary income. The Searle agreement was later canceled.

In 1949, Marco granted Marco Industries exclusive rights west of the Mississippi for the life of the patents, receiving 10% of sales, treated as capital gains.

The Signal agreement was extended, and Signal's rights were assigned to Dial Light Co.

In 1950, Marco and Dial Light modified their agreement to extend it for the life of the patents and explicitly grant Dial Light the right to 'use' the devices, in addition to manufacture and sell. Payments continued as 10% of gross sales.

In 1951, Marco received payments from both Marco Industries and Dial Light, treating the former as capital gains and the latter as ordinary income on his tax return.

Procedural History

The Commissioner of Internal Revenue determined a tax deficiency, arguing that

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income from Marco Industries should be taxed as ordinary income, not capital gains.

Marco petitioned the Tax Court, arguing that both the income from Marco Industries and Dial Light should be treated as capital gains and claiming an overpayment due to incorrectly reporting Dial Light income as ordinary income.

Issue(s)

1. Whether payments received from Marco Industries in 1951 are royalty income from licensing patents or proceeds from the sale of patents, taxable as long-term capital gain?

2. Whether payments received from Dial Light Co. in 1951 are royalty income from licensing patents or proceeds from the sale of patents, taxable as long-term capital gain?

Holding

1. Yes, for payments from Marco Industries. The payments are proceeds from the sale of patents and taxable as long-term capital gain because Marco transferred exclusive rights to manufacture, use, and sell for the life of the patents.

2. Yes, for payments from Dial Light Co. The payments are also proceeds from the sale of patents and taxable as long-term capital gain because the modified agreement granted exclusive rights to manufacture, use, and sell for the life of the patents.

Court's Reasoning

The court relied on established precedent, particularly *Waterman v. Mackenzie*, 138 U.S. 252 (not a tax case, but defining sale vs. license) and *Edward C. Myers, 6 T.C. 258*, which applied *Waterman* in a tax context.

The court emphasized that "the grant of the exclusive right to manufacture, use, and sell a patented article constitutes a sale of the patent rights with the proceeds taxable as long-term capital gain."

For Marco Industries, the agreement explicitly granted the "sole and exclusive right to manufacture, make, use and sell" for the life of the patents, clearly meeting the criteria for a sale.

For Dial Light, while the initial agreement was a license, the 1950 modification, extending the term to the life of the patents and adding the right to "use," transformed it into a sale. The court noted the stipulated fact that the modified agreement granted Dial Light the right to "manufacture, make, use and, sell the devices during the extended term."

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The court distinguished cases cited by the Commissioner, such as *Ernest E. Rollman, 25 T.C. 481*, where the transfer lacked the right to 'use' the patent, thus remaining a license.

The court acknowledged Section 1235 of the 1954 Code, which codified capital gains treatment for patent transfers but noted it was not applicable to 1951 income, basing its decision on pre-existing case law.

Practical Implications

Marco v. Commissioner clarifies the distinction between a sale and a license of patent rights for tax purposes. Attorneys drafting patent transfer agreements must ensure that if capital gains treatment is desired, the agreement conveys exclusive rights to manufacture, use, and sell the patented invention for the entirety of its patent life.

The case highlights that even agreements initially structured as licenses can be re-characterized as sales if they are amended to include all substantial rights for the patent's duration. The explicit grant of the right to 'use' the invention, in addition to manufacture and sell, is a significant factor supporting sale treatment.

This decision emphasizes a substance-over-form approach, focusing on the comprehensive transfer of patent rights rather than the label attached to the agreement. It remains relevant for analyzing patent transfers under pre- and post-Section 1235 law, particularly when determining whether a transfer constitutes a sale or a license for capital gains eligibility.

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