Graham v. Commissioner, 26 T.C. 730 (1956)

A transfer of a patent constitutes a sale, eligible for capital gains treatment, if the transferor conveys all substantial rights to the patent, even if the consideration includes royalties or is contingent on future events.

Summary

In *Graham v. Commissioner*, the U.S. Tax Court addressed whether payments received by an inventor for the transfer of patent rights should be taxed as ordinary income or as long-term capital gain. The court determined that the agreement between the inventor and a corporation, in which the inventor held a minority stake, constituted a sale of the patent. The court focused on the substance of the transaction rather than its form, emphasizing that the inventor transferred all substantial rights to the patent, entitling him to capital gains treatment. The court rejected the IRS's argument that the transaction lacked arm's length dealing because the inventor held a stake in the corporation, and it found that certain elements of the agreement, such as royalty-based payments and the retention of some rights, did not negate the fact that the transfer was, in substance, a sale.

Facts

Thornton G. Graham and Albert T. Matthews jointly owned a patent for a ventilated awning. They entered into an agreement with National Ventilated Awning Company, a corporation, in which Graham and Matthews held a combined minority interest. The agreement transferred to the corporation all rights, title, and interest in the patent, including the right to collect royalties from existing licensees and future infringers. The consideration included royalties from existing licensees, a percentage of royalties from new licenses, and an amount equal to infringement recoveries. The IRS argued that payments received by Graham under the agreement constituted ordinary income because the transaction was not an arm's-length sale of the patent.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the petitioners' income tax liability. The petitioner contested the determination, arguing that the payments received were long-term capital gains. The case was heard in the United States Tax Court.

Issue(s)

1. Whether the agreement between Graham and the corporation constituted a sale of the patent rights, or a license, and therefore if the payments received by Graham should be taxed as long-term capital gains or ordinary income.

2. Whether the transaction was at arm's length, considering the patent owners'

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ownership in the corporation.

Holding

1. Yes, the agreement constituted a sale of the patent rights because Graham transferred all substantial rights to the patent.

2. Yes, the transaction was at arm's length because a significant minority interest of the corporation was not controlled by the patent owners.

Court's Reasoning

The court relied on the principle that the substance of a transaction, not its form, determines its tax treatment. It cited *Waterman v. Mackenzie, 138 U.S. 252 (1891)* to support its view that whether an agreement is an assignment or a license does not depend on the name used but the legal effect of its provisions. The court found that the agreement transferred all right, title, and interest in the patent, including the right to sue for infringement. The fact that the corporation was not wholly owned by the patent holders was critical to the court's finding that the transaction was at arm's length, thus rejecting the IRS's argument that the transaction was a device to convert ordinary income into capital gains. The court further held that provisions for royalty-based payments and the retention of certain rights, such as those concerning infringement recoveries, did not negate the sale. The court stated, "It is well established that the transfer by the owner of a patent of the exclusive right to manufacture, use, and sell the patented article in a specific territory constitutes a sale of the patent…"

Practical Implications

This case is significant because it provides guidance on the tax treatment of patent transfers. It clarifies that even if the consideration for the patent transfer includes royalties, or other payments tied to the success of the patent, the transfer can still be treated as a sale, provided the patent holder transfers all substantial rights. This has implications for individuals and businesses involved in the sale or licensing of patents. The case also underscores the importance of structuring transactions to ensure they are at arm's length, particularly when related parties are involved. Furthermore, the case provides that a patent holder can receive an amount equal to infringement recoveries, and still have the transaction considered a sale of patent rights. Counsel should carefully draft patent transfer agreements to reflect an outright transfer of rights and structure the consideration in a manner consistent with a sale. The decision in *Graham* remains relevant in distinguishing between a license and a sale of a patent, and determining the appropriate tax treatment of such transactions. Subsequent courts and legal scholars have cited *Graham*, as it still provides a useful framework for analyzing the tax treatment of patent transfers.

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