26 T.C. 869 (1956)

Royalty payments received under a contract right, even when adjusted through a settlement agreement, are generally treated as ordinary income and not capital gains unless they are derived from the sale or exchange of a capital asset, such as a patent.

Summary

In *Scott v. Commissioner*, the U.S. Tax Court addressed whether royalty payments received by a taxpayer constituted ordinary income or capital gains. The taxpayer received a percentage of royalties from a patent license agreement. After a settlement agreement was reached with the company paying the royalties, the taxpayer claimed capital gains treatment for the payments. The court held that the payments were ordinary income because the taxpayer did not sell or exchange any interest in a patent but merely received payments under an existing contract right. The court emphasized that for capital gains treatment, there must be a sale or exchange of a capital asset, and a mere settlement of claims does not qualify as such a transaction.

Facts

Don O. Scott acquired a 12% interest in royalties from a patent license agreement in exchange for his Laundri-Matic stock. He later gifted this interest to his wife, Anne B. Scott. The company obligated to pay these royalties was later acquired by Avco Manufacturing Corporation. Controversies arose involving royalty payments under the agreement, leading to a settlement. The settlement agreement resolved several disputes regarding the scope of the licensed patents and the amount of royalties. Anne B. Scott received payments from Avco under the settlement. She reported a portion of the payments as ordinary income and the remainder as long-term capital gains, claiming they resulted from the sale of an interest in patents.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the income tax of the Scotts, disallowing the capital gains treatment claimed for a portion of the royalty payments. The Scotts challenged the Commissioner’s determination in the United States Tax Court.

Issue(s)

1. Whether Anne B. Scott, through the settlement agreement, sold or exchanged any interest in a patent, allowing the payments to qualify for capital gains treatment.

Holding

1. No, because Anne B. Scott did not sell or exchange any interest in a patent or

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contract right through the settlement agreement, the payments are considered ordinary income.

Court’s Reasoning

The court’s central focus was whether the settlement qualified as a

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