Scott v. Commissioner, 29 T.C. 878 (1958)

A compromise settlement of royalty payments does not constitute a "sale or exchange" of a capital asset, and payments received under such a settlement are taxable as ordinary income, not capital gains, when the taxpayer's interest was solely a contract right to receive royalties.

Summary

In *Scott v. Commissioner*, the Tax Court addressed whether payments received by Anne B. Scott from Avco Manufacturing Corporation, pursuant to a settlement agreement resolving royalty disputes, qualified as long-term capital gains. Scott had received an assignment of a contract right entitling her to a percentage of royalties from a patent licensing agreement. The court determined that because Scott's interest was solely a contract right to receive royalty payments and the settlement did not involve a sale or exchange of that right, the payments she received were taxable as ordinary income, not capital gains. This case clarifies that settlement of a debt or dispute over royalty payments doesn't constitute a "sale or exchange" necessary for capital gains treatment.

Facts

Don O. Scott, in 1936, relinquished his stock in Laundri-Matic Corporation in exchange for a contract right to receive 12% of royalties from a patent license agreement. In 1940, he gifted this contract right to his wife, Anne B. Scott. Avco Manufacturing Corporation eventually became the exclusive licensee of the patents. In 1951, Anne B. Scott, along with other royalty claimants, entered into a settlement agreement with Avco to resolve disputes over royalty payments. The settlement modified the royalty rates and determined the distribution of royalties among different claimants. The IRS determined the settlement payments received by Anne Scott constituted ordinary income, not capital gains.

Procedural History

The case was heard by the United States Tax Court. The court ruled in favor of the Commissioner of the Internal Revenue, determining the payments received by the taxpayer were ordinary income, not capital gains. The court found the nature of the asset (contract right to receive royalties) and the character of the transaction (settlement of a royalty dispute) led to this conclusion. The court's ruling upheld the IRS's original determination that the amounts received were ordinary income, subject to standard income tax rates rather than preferential capital gains rates.

Issue(s)

Whether the payments received by Anne B. Scott from Avco Manufacturing Corporation pursuant to a settlement agreement constituted a "sale or exchange" of a capital asset, thereby qualifying as long-term capital gain under Section 117 of the

Internal Revenue Code of 1939.

Holding

No, because the settlement of a contract right to receive royalties does not constitute a “sale or exchange” within the meaning of Section 117 of the 1939 Code. Therefore, the payments are taxable as ordinary income.

Court’s Reasoning

The court’s reasoning focused on the nature of the asset and the nature of the transaction. The court found that Anne B. Scott held a contract right, not a proprietary interest, to receive royalty payments. The settlement agreement did not involve a sale or exchange of that right; it simply resolved disputes over the amount and distribution of those royalties. The court emphasized that Scott had no title or proprietary interest in any patent. Citing *Hale v. Helvering*, the court stated, “A compromise of indebtedness is not ‘a sale or exchange,’ within the meaning of section 117 of the 1939 Code.

