27 T.C. 265 (1956)

The transfer of a patent, even if the employer holds shop rights, qualifies for capital gains treatment under Section 117(q) of the 1939 Code if the inventor transfers all substantial rights.

Summary

In 1945, an inventor assigned his patent rights to his employer in exchange for royalties. The invention was developed by the inventor on his own time, but a pilot model was made at the employer's premises with the help of other employees. The Commissioner of Internal Revenue argued the inventor didn't transfer all substantial rights due to the employer's shop rights. The Tax Court held that the inventor was entitled to treat the royalties as long-term capital gains, as the employer's shop rights did not dilute the inventor's substantial rights in the patent within the meaning of Section 117(q) of the 1939 Code.

Facts

Hans Jordan, an electrical engineer, conceived of a waste disposal unit in 1943. He developed it on his own time, with assistance and materials provided by his employer, Given Machinery Company. Jordan and Given Machinery Company entered an agreement on August 22, 1945. Jordan assigned all rights, title, and interest in the patent to Given Machinery Company in exchange for 1% of the net selling price of each unit sold. The agreement included a clause stating Jordan invented the waste disposal unit as part of his duties while employed by Given. The Given Machinery Company later assigned its rights to Given Manufacturing Company. In 1951 and 1952, Jordan received payments under the 1945 agreement and reported them as long-term capital gains. The Commissioner determined these sums constituted ordinary income.

Procedural History

The case was initially submitted to the Tax Court on a full stipulation of facts. The court reopened the case to receive further testimony from the petitioner and another witness. The Tax Court ruled in favor of the petitioner, holding the royalties were properly reported as long-term capital gains.

Issue(s)

1. Whether amounts received by the petitioner in 1951 and 1952 were proceeds from the sale of a patent and, therefore, taxable as long-term capital gains under Section 117(q) of the 1939 Code.

Holding

1. Yes, because the transfer of the patent met the requirements of a sale or

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exchange of a capital asset under the applicable code, even though the employer possessed shop rights.

Court's Reasoning

The court addressed the core issue of whether Jordan transferred "all substantial rights" to the patent, as required by Section 117(q) of the 1939 Code for capital gains treatment. The Commissioner argued Jordan didn't transfer all rights due to a clause in the agreement stating the invention was made "as part of his duties" and that this gave the employer patent rights. The court found this argument without merit. Both Jordan and Bert Given testified that the clause was likely included by the lawyer and that it was not a critical term in the agreement. The court determined the employer only possessed shop rights. Referring to the definition of shop rights, the court stated, "the employer in such a case has no equity to demand a conveyance of the invention, which is the original conception of the employee alone, in which the employer had no part. This remains the property of him who conceived it, together with the right conferred by the patent, to exclude all others than the employer from the accruing benefits."

The Court emphasized that the shop right merely grants the employer a non-exclusive right to use the invention and does not diminish the inventor's substantial rights to a patent.

Practical Implications

This case is critical for determining when patent royalties qualify for capital gains treatment. It clarifies that the existence of employer shop rights, while potentially affecting the employer's use of the invention, does not necessarily preclude the inventor from claiming capital gains. In similar cases, the key inquiry is whether the inventor transferred all *substantial* rights to the patent, which includes the right to exclude others, even if the employer retains a non-exclusive right to practice the invention. The court's interpretation of

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