***Potter v. Commissioner*, 27 T.C. 200 (1956)**

When a grantor establishes an irrevocable trust and validly assigns a patent application to the trust, with no retained control over the patent, the trust income from royalties is not taxable to the grantor under the *Clifford* doctrine, and royalty payments made by the grantor to the trust are deductible as ordinary and necessary business expenses if they are reasonable.

Summary

J.T. Potter created irrevocable trusts for his children, assigning a patent application for a decade-counting device to the trusts. He then licensed the patent application back from the trusts, paying royalties. The IRS argued that the income from the trusts should be taxed to Potter, and that the royalty payments were not deductible. The Tax Court held that the assignment to the trusts was valid, and that because Potter did not retain control over the patent, the income was not taxable to him. The Court also found that the royalty payments were reasonable and deductible. The court also addressed the deductibility of interest payments the taxpayer made on behalf of his children, and whether the taxpayer was subject to penalties for failing to file a declaration of estimated tax. The Tax Court ruled in favor of Potter on most issues, determining that the royalty income belonged to the trusts, and that the royalty payments made to the trust were deductible.

Facts

J.T. Potter (the taxpayer) developed a decade-counting device and filed a patent application. He established irrevocable trusts for his children, assigning the patent application to the trusts. Potter then entered into a non-exclusive license agreement with the trusts, under which he was to pay royalties for the use of his invention. The IRS audited Potter’s tax returns for 1945 and 1946, determining that the income of the trusts was taxable to him, that the royalty payments were not deductible, and that Potter was liable for penalties for failure to file an estimated tax return. Potter contested these determinations in the Tax Court.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency to J.T. Potter. Potter petitioned the Tax Court for a redetermination of his tax liability. The Tax Court heard the case, analyzed the evidence, and issued a decision in favor of the taxpayer on most issues.

Issue(s)

1. Whether the income from the trusts was taxable to Potter under the *Clifford* doctrine because he retained excessive control over the patent.

2. Whether the royalty payments made by Potter to the trusts were deductible as

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ordinary and necessary business expenses.

3. Whether Potter was entitled to deduct interest payments he made on behalf of his children.

4. Whether the interest on government bonds received by the trusts should be included in Potter's income.

5. Whether Potter was liable for a penalty for failure to file a declaration of estimated tax.

Holding

1. No, because Potter made a valid assignment of the patent and did not retain the requisite control.

2. Yes, because the royalty payments were reasonable and represented an ordinary and necessary business expense.

3. Yes, the taxpayer was entitled to deduct the interest payments made on behalf of his children.

4. No, the taxpayer was not required to include the interest on government bonds received by the trusts.

5. Yes, the taxpayer was liable for the penalty for failure to file a declaration of estimated tax.

Court's Reasoning

The court first addressed the validity of the assignment of the patent application to the trusts. The court found the assignment to be valid based on the recorded instrument and Potter's acknowledgement before a notary, satisfying the requirements of 35 U.S.C. § 47 (as it existed in 1944). The court then analyzed whether the trust income was taxable to Potter under the *Clifford* doctrine, which addressed whether the grantor maintained sufficient control over the trust. The court considered that the trust was irrevocable and the trustees were independent. Potter had not retained power to change beneficiaries, direct income accumulation, or change trustees. The trusts were valid and changed Potter's economic status with respect to the patent. The court concluded that Potter had relinquished sufficient control and therefore the trust income was not taxable to him.

Next, the court evaluated the deductibility of the royalty payments. Relying on the holding in *Limericks, Inc. v. Commissioner*, the court held that excessive royalty payments were not deductible. However, the court found that the royalty rate agreed upon between Potter and the trusts was reasonable at the time of the agreement, and therefore deductible as an ordinary and necessary business

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expense.

The court next addressed the deductibility of the interest payments. The court found that the payments were made and constituted deductible interest.

Finally, the court addressed the penalty for failure to file an estimated tax return, concluding that Potter had not presented sufficient evidence that the failure was due to reasonable cause and not willful neglect.

Practical Implications

This case illustrates the importance of a properly structured trust and the transfer of assets to it. To avoid having trust income attributed to the grantor, the grantor must relinquish substantial control. A grantor can validly assign a patent application to an irrevocable trust, and license it back, but must do so at a reasonable royalty rate to have the payments be considered ordinary and necessary business expenses.

This case also illustrates how the Clifford doctrine can be applied in cases involving trusts. Courts will closely examine the degree of control retained by the grantor to determine the tax treatment of the trust income.

The ruling also indicates that if interest payments are made and the underlying debt is bona fide, they are deductible, assuming the taxpayer meets all the requirements of the Internal Revenue Code.

This case highlights that reliance on others to file taxes is not sufficient to avoid penalties for failing to file a declaration of estimated tax, unless there is proof that the failure was due to reasonable cause and not willful neglect.

Later cases regarding the *Clifford* doctrine and tax avoidance continue to apply similar analyses of control and economic benefit to determine who is responsible for the income tax burden.

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