27 T.C. 346 (1956)

An exclusive license agreement transferring all substantial rights to a patent is considered a sale or exchange of a capital asset, entitling the patent holder to treat payments received as long-term capital gains, regardless of payment structure, under specific provisions of the Internal Revenue Code.

Summary

The case addresses whether payments received under an exclusive patent license agreement are taxable as long-term capital gains or ordinary income. The taxpayer, an inventor, granted a corporation an exclusive license to his patents and future improvements. The Tax Court, applying the newly enacted Section 117(q) of the 1939 Code, held that the license agreement constituted a sale of a capital asset, entitling the inventor to capital gains treatment. The court emphasized the transfer of all substantial rights in the patents, irrespective of how payments were structured. It also addressed and rejected an attempt by the Commissioner to introduce a new issue on brief that was not raised earlier in the proceedings.

Facts

Frank H. Philbrick (Philbrick), an engineer and inventor, owned several patents related to machines used in railroad maintenance. In 1947, he entered into an exclusive license agreement with Pullman-Standard Car Manufacturing Company (Pullman), granting Pullman the right to make, use, and sell machines embodying Philbrick's inventions, as well as any future improvements. The agreement included upfront payment and royalties. Philbrick also entered into an employment contract with Pullman. Philbrick reported payments received under the license agreement as long-term capital gains. The Commissioner of Internal Revenue, in the notice of deficiency, determined that the payments were "royalties" taxable as ordinary income. The Commissioner also attempted to introduce on brief a new issue arguing for compensation for personal services for royalties attributed to inventions that Philbrick made after the license agreement, but before the employment contract.

Procedural History

The Commissioner issued a notice of deficiency, asserting that payments under the patent license agreement were ordinary income. Philbrick petitioned the Tax Court. The Tax Court heard the case, including post-trial briefs. The Tax Court determined that Philbrick was entitled to capital gains treatment. The Commissioner attempted to raise an additional issue on brief, but the Tax Court rejected it as untimely.

Issue(s)

1. Whether payments received by Philbrick under the exclusive license agreement are taxable as long-term capital gains or ordinary income.

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2. Whether the Commissioner was permitted to raise a new issue for the first time in his brief.

Holding

1. Yes, because the exclusive license agreement transferred all substantial rights to the patents, making the payments subject to capital gains treatment under Section 117(q) of the 1939 Code.

2. No, because the Commissioner's attempt to raise a new issue in the brief, not previously raised in the notice of deficiency or pleadings, was untimely and improper.

Court's Reasoning

The court applied Section 117(q) of the 1939 Internal Revenue Code, enacted to address the tax treatment of patent transfers. This section specified that a transfer of all substantial rights to a patent by a "holder" (defined as the inventor or their assignee before the invention was put in practice) is considered a sale or exchange of a capital asset. The Court found that Philbrick was a

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