29 T.C. 389 (1957)

Royalties paid under a license agreement may not be deductible as ordinary business expenses if the agreement only covers improvements on existing patents. Constructive dividends may be taxed as income to the owner if the owner controls the source of income and diverts it to others.

Summary

The U.S. Tax Court considered several consolidated cases involving Frank E. Best, his company, and the Best Foundation, Inc. The court addressed the tax treatment of royalty payments, whether certain payments to the Foundation were constructive dividends to Best, and if the Foundation qualified as a tax-exempt organization. The court ruled that royalty payments made by Best Lock Corporation were not deductible business expenses because the underlying license covered improvements already assigned. The court found that royalty payments from Best Lock to the Foundation were constructive dividends taxable to Best because he controlled the corporations and the diversion of funds. Finally, it determined the Best Foundation was not tax-exempt, because its activities extended beyond the permissible scope outlined in section 101(6) of the Internal Revenue Code.

Facts

Frank E. Best, an inventor, assigned his patents to Best, Inc., which later licensed Best Lock Corporation. Best then organized the Best Foundation. Best Universal Lock Co., Inc., was formed as a subsidiary to Best Lock Corporation. In 1949, Best gave an exclusive license to the Foundation to manufacture a new lock. The Foundation sublicensed Best Lock to manufacture the lock in exchange for royalties. Best Lock made payments in 1951 and 1952 in preparation of a catalog issued in 1953. The Foundation, controlled by Best, engaged in activities beyond religious, charitable, or scientific purposes including lending money, making investments, and supporting Best's interests. The IRS challenged the deductibility of certain payments made by the Best Lock Corporation and the exempt status of The Best Foundation, Inc.

Procedural History

The Commissioner of Internal Revenue issued deficiencies in income tax against Best, Best Lock Corporation, and the Best Foundation. The petitioners filed petitions in the U.S. Tax Court. The cases were consolidated for trial. The Tax Court held the issues. The court determined that royalty payments made by Best Lock Corporation were not deductible business expenses and that payments to the Foundation were constructive dividends to Best, and that the Foundation was not tax-exempt. The dissenting opinion was filed by Judge Pierce, who believed the court should have followed the Court of Appeals' decision in E. H. Sheldon & Co. v. Commissioner, 214 F.2d 655, regarding the catalog expenses.

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Issue(s)

1. Whether royalty payments made by Best Lock Corporation to Best and the Best Foundation were deductible as ordinary and necessary business expenses.

2. Whether royalty payments to the Best Foundation constituted constructive dividends to Frank E. Best.

3. Whether the Best Foundation, Inc., was exempt from federal income tax under section 101(6) of the Internal Revenue Code of 1939.

Holding

1. No, because the royalty payments were for inventions already covered under the license to Best Lock and therefore were not ordinary or necessary business expenses.

2. Yes, because Best controlled the source of the income and the diversion of payments to the Foundation, making the payments taxable as dividends to him.

3. No, because the Best Foundation was not exclusively operated for religious, charitable, scientific, or educational purposes.

Court's Reasoning

The court followed the precedent set in *Thomas Flexible Coupling Co. v. Commissioner*, 158 F.2d 828, which held that additional royalty payments for improvements on existing patents were not deductible when the original license covered improvements. The court found that the 1949 license covered improvements related to the Best Universal Locking System and thus the payments were not necessary business expenses. The court applied *Helvering v. Horst*, 311 U.S. 112, and *Commissioner v. Sunnen*, 333 U.S. 591, to determine whether Best had enough control over the income. Because Best controlled both the corporations and the distribution of the funds, the court found the payments constituted constructive dividends. Finally, the court relied on *Better Business Bureau v. United States*, 326 U.S. 279, which held that an organization must be exclusively dedicated to exempt purposes to qualify for exemption. The court found that the Foundation's activities were not exclusively for exempt purposes.

Practical Implications

This case clarifies that royalty payments for improvements to existing patents are not always deductible, particularly when the original licensing agreements cover the improvements. It underscores the importance of thoroughly reviewing licensing agreements to ascertain the scope of the license. The case is a reminder that the IRS can challenge expenses not deemed ordinary and necessary, especially where controlling ownership is involved. Also, this case shows how the IRS can

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recharacterize payments. Finally, the case sets forth a clear standard for determining when income is taxed to the person controlling it, and not to the entity receiving it. Organizations must adhere strictly to their stated exempt purposes to qualify for tax-exempt status. This requires ongoing monitoring of an organization’s activities to ensure continued compliance with IRS regulations.

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