30 T.C. 974 (1958)

The transfer of a patent by an inventor to a controlled corporation, where the inventor retains no proprietary interest and receives payments based on the corporation's sales, is a sale entitling the inventor to capital gains treatment, not ordinary income, provided the transaction serves a legitimate business purpose.

Summary

Herbert C. Johnson, an inventor and sole owner of the common stock of National Die Casting Company, Inc. (National), transferred patents to the corporation in exchange for a percentage of the corporation's sales of products using the patents. The IRS contended that these payments were royalties, taxable as ordinary income. The Tax Court held that the transfer constituted a sale of a capital asset, entitling Johnson to long-term capital gains treatment. The court emphasized that the transaction was bona fide, served a valid business purpose, and was fair and reasonable, despite the fact that the transferor owned the corporation.

Facts

Herbert C. Johnson, a tool and die casting designer, owned several patents for a fruit juice extractor. In 1941, he formed National, transferring most of his manufacturing assets to the corporation but initially retaining the patents and certain real estate. He did so to shield these assets from the potential liabilities arising from the corporation's war work. National manufactured and sold fruit juice extractors covered by the patents. Johnson allowed National to use his patents without compensation during that time. After the war and contract renegotiation, Johnson decided to transfer the patents to National. On November 17, 1947, Johnson entered into a written agreement with National to sell the patents, receiving 6% of the selling price of products using the patents and 80% of any royalties from licensing. Johnson owned all the common stock of National, while his wife and sons owned all the preferred stock. The payments received under this agreement became the subject of the tax dispute.

Procedural History

The Commissioner of Internal Revenue determined income tax deficiencies against Johnson, arguing that the payments received from National should be taxed as ordinary income. The Johnsons petitioned the Tax Court, challenging the IRS's determination and claiming long-term capital gains treatment was appropriate. The Tax Court heard the case and ruled in favor of the Johnsons.

Issue(s)

1. Whether payments received by Johnson from National, representing a percentage of sales of products covered by the patents, constitute ordinary income or long-term capital gains.

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2. Whether the transfer of the patents to National was a bona fide sale or a transaction lacking a valid business purpose, given Johnson's control of the corporation.

Holding

1. Yes, the payments are considered long-term capital gains because the transfer of the patent was deemed a sale and not a license agreement.

2. Yes, the transfer was a bona fide sale made for a valid business purpose, despite Johnson's control over the corporation.

Court's Reasoning

The court began by establishing that the transfer of a patent can result in capital gain or loss if the patent is a capital asset in the transferor's hands and if the transaction constitutes a sale or assignment, not merely a license. It rejected the IRS's argument that payments contingent on sales are automatically royalties, classifying them as capital gains. The court cited precedent supporting the treatment of such payments as capital gains. It found the transaction to be a sale and emphasized that the agreement was fair and reasonable. The court refuted the IRS's claim that the transaction was a sham, finding a legitimate business purpose behind Johnson's actions. The court noted Johnson's initial reluctance to transfer the patents, due to concerns about liabilities during the war effort, and concluded that the arrangement was not merely an attempt to avoid taxes but a practical business decision. The court emphasized that National operated as a separate entity and the sale of the patents was an arm's-length transaction, even though between Johnson and his wholly-owned corporation.

Practical Implications

This case is critical for business owners and inventors as it allows for capital gains treatment in the sale of patents to their controlled corporations, under specific conditions. The ruling reinforces the importance of documenting a valid business purpose for the transaction, even in closely held corporations. It confirms that payments tied to production or sales do not automatically preclude capital gains treatment. This decision is crucial for tax planning. Lawyers should advise clients about the necessity of structuring transactions carefully to reflect a genuine sale of the asset. They also must document the business reasons for the arrangement, and ensure the terms are fair and reasonable.

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