***33 T.C. 743 (1960)***

A modification agreement that converts a royalty-based license into a fixed-price purchase of patents creates a depreciable capital asset, but the resulting payment obligations do not automatically qualify as borrowed capital for excess profits tax credit purposes unless evidenced by specific instruments.

**Summary**

In 1950, McCullough Tool Co. (petitioner) modified its existing patent license agreements with the patent holders to convert royalty payments into fixed monthly installments for the purchase of the patents. The Tax Court addressed two issues: whether these modification agreements created a depreciable asset and whether the installment obligations constituted borrowed capital for the calculation of the petitioner's excess profits credit. The Court held that the modification agreements did create a depreciable capital asset. However, it also determined that the installment payment obligations did not qualify as borrowed capital under the Internal Revenue Code because they were not evidenced by a bond, note, or other specified instrument as required by the statute. The court's decision hinged on the specific language and nature of the agreements.

**Facts**

McCullough Tool Company (the petitioner) had exclusive license agreements for certain patents related to oil well perforation technology. These agreements, initially structured with royalty payments, were modified in 1950. The modifications converted the royalty-based payment structure into a fixed price payable in monthly installments. The initial agreements, made in 1944 and 1947, granted exclusive licenses for patents. The 1950 modification agreements converted the agreements to ones of purchase and sale of the patents, with payments made in fixed monthly installments over a set period. McCullough Tool Co. sought to deduct depreciation on the patents after the modification agreements were made. The IRS disallowed the depreciation deductions, arguing that the agreements didn't create a fixed cost basis. The IRS also denied the inclusion of the installment obligations as borrowed capital for excess profits tax calculations.

**Procedural History**

The Commissioner of Internal Revenue determined deficiencies in McCullough Tool Co.'s income and excess profits taxes for 1951 and 1952. The deficiencies resulted from the disallowance of deductions for depreciation of certain patents and disallowance of the inclusion of certain sums as borrowed capital in the computation of the company's excess profits credit. The case was brought before the United States Tax Court. The Tax Court's decision was made under Rule 50, indicating that the Court provided an opinion to resolve the issues and the parties would then calculate the tax liability in accordance with the Court's ruling.

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## Issue(s)

1. Whether the 1950 modification agreements created a fixed cost for the patents, thereby allowing for depreciation deductions?

2. Whether the installment obligations under the modification agreements constituted “borrowed capital” for the purpose of calculating the excess profits credit?

## Holding

1. Yes, because the modification agreements substituted the royalty payments with fixed monthly installments, thereby creating a fixed cost basis for the patents, which is subject to depreciation.

2. No, because the installment obligations did not meet the statutory requirements for “borrowed capital,” as they were not evidenced by a bond, note, or other specified instrument.

## Court’s Reasoning

The court first addressed whether the modification agreements created a depreciable asset. The court emphasized that the 1950 agreements fundamentally altered the nature of the payment obligations. The modification agreements substituted the original obligation to pay royalties dependent upon gross receipts with new obligations to make payments of sums certain over specified shorter periods of time, therefore creating a depreciable asset. The court found that the payments made under the modification agreements were directly attributable to the purchase of the patents, which established a fixed cost basis. Second, the court addressed the issue of “borrowed capital.” The court examined whether the payment obligations were “evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, deed of trust, bank loan agreement, or conditional sales contract.” The court found that the modification agreements did not meet the criteria, noting that the obligations were not evidenced by a “note” (defined as a promissory note) or a “conditional sales contract.” The court referenced prior case law, specifically, *Journal Publishing Co.*, to support its conclusion that the mere existence of a contract did not satisfy the requirement for a “note” under the statute. The court concluded the modification agreements effected completed sales and not conditional sales.

## Practical Implications

This case underscores the importance of carefully structuring agreements and understanding their tax implications. For attorneys, the ruling emphasizes the need to: (1) clearly document the substance of transactions to establish a depreciable asset; and (2) ensure that any financing arrangements intended to be treated as “borrowed capital” are properly documented using the specific instruments listed in

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the relevant tax code. This includes accurately reflecting the true nature of the transaction in the written agreements. The case also has implications for accounting and financial planning in businesses that acquire intellectual property through payment plans. It highlights the importance of considering the specific requirements for depreciation and for qualifying for excess profits tax credits. Later cases involving similar facts would likely cite this case to show how the courts interpret and apply those requirements.

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