34 T.C. 453 (1960)

When an individual sells a patent to a corporation in which the individual owns more than 80% of the stock, the proceeds are taxed as ordinary income if the patent is a depreciable asset in the hands of the corporation.

Summary

Royce Kershaw, an inventor and shareholder, sold a patent for a railroad ballast spreader to a corporation he controlled. The IRS determined the proceeds were ordinary income, not capital gains. The Tax Court agreed, ruling that under Section 1239 of the 1954 Internal Revenue Code, the sale of depreciable property between an individual and a controlled corporation (defined as greater than 80% ownership) results in ordinary income treatment. Because the corporation could depreciate the patent, and Kershaw's ownership exceeded the statutory threshold, the income was taxed as ordinary income. The Court emphasized that the patent's depreciable nature was the key factor in this determination.

Facts

Royce Kershaw, a non-professional inventor, obtained a patent for a railroad ballast spreader. He sold the patent to Kershaw Manufacturing Company, Inc., a corporation primarily owned by himself, his wife, and his son. The corporation agreed to pay Kershaw a percentage of sales revenue from the patented product. During 1956, Kershaw received payments from the corporation based on sales of the patented device, reporting the income as capital gains. The IRS contested this, arguing the income was ordinary income.

Procedural History

Kershaw filed a joint income tax return for 1956, reporting the proceeds from the patent sale as capital gains. The IRS issued a deficiency notice, asserting the payments were ordinary income. Kershaw petitioned the United States Tax Court to challenge the IRS's determination. The Tax Court reviewed the facts and the applicable law and sided with the IRS.

Issue(s)

1. Whether the proceeds from the sale of the patent to the controlled corporation should be taxed as capital gains or ordinary income.

Holding

1. No, because under Section 1239 of the Internal Revenue Code, the proceeds are taxable as ordinary income.

Court's Reasoning

The court applied Section 1239 of the 1954 Internal Revenue Code, which addresses the sale of depreciable property between an individual and a controlled corporation. This section provides that any gain from such a sale is taxed as ordinary income if the individual owns more than 80% of the corporation's stock. The court found that Kershaw and his family held more than 80% of the corporation's stock. The court also determined that a patent is a depreciable asset. The court cited American Chemical Paint Co. v. Commissioner, recognizing that patents are subject to depreciation, thus falling squarely within the scope of Section 1239. The court rejected Kershaw's argument that Section 1239 should not apply to intangible assets like patents, stating that the statute did not contain any such limitation.

Practical Implications

This case illustrates the importance of understanding the definition of "related persons" in the tax code and how it impacts the tax treatment of transactions. Specifically, taxpayers should carefully consider the ownership structure of a corporation before selling depreciable property, including patents, to it. When an individual sells a patent to a controlled corporation, the sale will likely generate ordinary income if the patent is depreciable in the hands of the corporation, and if the individual and their family own more than 80% of the corporation's stock. The depreciable nature of the asset is crucial. Future cases involving the sale of intellectual property to closely held corporations will be analyzed using the framework established in this case. Legal practitioners must advise clients to structure these types of transactions carefully to achieve the desired tax outcome. The case also highlights the broad interpretation of "depreciable property" under Section 1239, extending beyond tangible assets.

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