***Chilton v. Commissioner*, 40 T.C. 552 (1963)**

Payments received by an inventor-employee for patent transfers to their employer can qualify as capital gains under Section 1235 I.R.C. 1954, if the employee was not specifically 'hired to invent'.

Summary

Roland Chilton, an engineer, received payments from Curtiss-Wright based on patents he assigned under employment contracts. The IRS argued these were ordinary income as compensation. The Tax Court disagreed, holding Chilton was not 'hired to invent'. His contracts were for transferring inventions, not just general engineering services. Royalty payments were thus capital gains from patent sales under Section 1235 I.R.C. 1954. This case distinguishes between compensation for inventive services and capital gains from patent transfers within employment.

Facts

Roland Chilton, an experienced aircraft engineer, contracted with Wright Aeronautical Corp. and later Reed Propeller Co. (both eventually Curtiss-Wright subsidiaries). His contracts required him to assign inventions related to aircraft engines to his employer. In return, he received a fixed annual salary and royalties based on sales of patented inventions. The contracts included a clause allowing Chilton to retain patent rights if the company did not accept an invention within 90 days of testing. Chilton spent a portion of his time on general engineering tasks and a portion on inventing. Wright and Reed consistently treated the royalty payments as such, not as salary or compensation.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Roland and Florence Chilton's income tax for 1954-1957, classifying royalty payments as ordinary income. The Chiltons petitioned the Tax Court. The Tax Court reversed the Commissioner's determination, holding the payments qualified for capital gains treatment under Section 1235 of the Internal Revenue Code of 1954.

Issue(s)

1. Whether payments received by Roland Chilton from Curtiss-Wright for patent rights constituted ordinary income as compensation for services, or long-term capital gains from the sale of patents under Section 1235 of the Internal Revenue Code of 1954?

Holding

1. No. The payments constituted long-term capital gains because Chilton was not 'hired to invent,' but had a contractual agreement to transfer his inventions, and he

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effectively transferred all substantial rights to those patents.

Court's Reasoning

The Tax Court distinguished between an employee 'hired to invent,' in which case inventions belong to the employer and payments are compensation, and a general employee with a contractual obligation to assign inventions. Citing *United States v. Dubilier Condenser Corp.*, the court noted that inventions made by those 'hired to invent' are inherently the employer's property. However, in Chilton's case, the court found the employment contracts and the conduct of the parties indicated he was not solely 'hired to invent'. The company's accounting practices treated the payments as royalties, and Chilton himself initially reported them as business income. While acknowledging some ambiguity in the contracts, the court concluded that the evidence showed Chilton's primary role was not solely invention, and the royalty payments were consideration for the transfer of patent rights, thus qualifying for capital gains treatment under Section 1235. The court emphasized that "Since the payments petitioner received with respect to the patents in accordance with his contracts with his employers were not compensation for services rendered 'as an employee,' the amounts were payments to petitioner for transfer to his employers of his inventions and patents. This is the very type of payment which section 1235 states shall be considered as received from the sale or exchange of a capital asset."

Practical Implications

Chilton v. Commissioner is crucial for determining the tax treatment of payments to employee-inventors. It underscores the importance of clearly defining the scope of employment contracts, particularly regarding inventive duties. The case suggests that if an employee's role extends beyond solely inventing, and royalty payments are explicitly linked to patent transfers, capital gains treatment under Section 1235 is attainable. Legal analysis in similar cases should focus on contract language, the parties' conduct, and the actual nature of the employment relationship to differentiate between compensation for services and capital gains from patent transfers. This decision impacts how businesses structure agreements with innovating employees and how inventors classify income from their patents when employed. Future cases will likely scrutinize employment agreements to ascertain whether employees were fundamentally 'hired to invent' or if their inventive activities were ancillary to broader employment responsibilities.

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