Greenberg v. Commissioner, 53 T. C. 327 (1969)

Royalties from a patent license are treated as capital gains only if the licensor transfers all substantial rights to the patent.

Summary

In Greenberg v. Commissioner, the Tax Court ruled that royalties from a patent license could not be treated as capital gains under Section 1235 of the Internal Revenue Code because the licensor did not transfer all substantial rights to the patent. The case involved a nonexclusive license granted to Fitzgerald, where the licensor retained significant control over the patent's future use. The court examined the license agreement and surrounding circumstances, concluding that the retained rights were of substantial value, thus the royalties should be taxed as ordinary income.

Facts

Greenberg and another individual co-owned a patent. In 1959, they entered into a nonexclusive license agreement with Fitzgerald, granting it the right to use the patent until 1966. The agreement allowed the licensors to retain control over the patent's use after 1966 and to potentially license it to others during the term of the Fitzgerald license. Greenberg argued that his co-owner's interest in Fitzgerald would prevent other licenses, but the court found this argument unpersuasive.

Procedural History

Greenberg sought to treat royalties received from Fitzgerald as capital gains under Section 1235. The Commissioner of Internal Revenue disagreed, arguing the royalties should be taxed as ordinary income. The case proceeded to the Tax Court, which heard arguments and reviewed evidence before issuing its decision.

Issue(s)

1. Whether the royalties received from Fitzgerald qualify as capital gains under Section 1235 of the Internal Revenue Code because the licensor transferred all substantial rights to the patent.

Holding

1. No, because the licensor did not transfer all substantial rights to the patent; the retained rights were of substantial value.

Court's Reasoning

The court applied Section 1235, which requires a transfer of all substantial rights to a patent for royalties to be treated as capital gains. The license agreement with

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Fitzgerald was nonexclusive and limited in duration, with the licensors retaining significant control over the patent's future use. The court examined the surrounding circumstances but found that the licensors' retained rights, including the ability to license the patent to others and renegotiate terms after 1966, were of substantial value. The court rejected Greenberg's argument that his co-owner's interest in Fitzgerald would prevent other licenses, citing the possibility of changed circumstances and the lack of evidence supporting this claim. The court referenced similar cases like Pickren v. United States, where a similar license did not transfer all substantial rights.

Practical Implications

This decision clarifies that for royalties from patent licenses to be treated as capital gains, the licensor must relinquish all substantial rights to the patent. Practitioners must carefully review license agreements to ensure they meet the criteria of Section 1235. The ruling impacts how businesses structure patent licensing agreements, potentially affecting their tax planning strategies. Subsequent cases, such as Pickren v. United States, have followed this reasoning, emphasizing the importance of transferring all substantial rights to qualify for capital gains treatment.

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