57 T.C. 600 (1972)

Payments for the transfer of technological know-how, as distinct from patent licenses, can qualify for capital gains treatment if all substantial rights in the know-how are conveyed to the purchaser.

Summary

Francis Shepard, an inventor, developed a high-speed printer. He entered into agreements with National Cash Register Co. (NCR), granting them rights related to his printer technology and patents. The Tax Court needed to determine whether payments from NCR to Shepard were royalties from patent licenses (taxed as ordinary income) or proceeds from the sale of technological know-how (eligible for capital gains). The court held that the payments were for the sale of technology, not merely patent licenses. Shepard conveyed all substantial rights to the technological know-how necessary to manufacture the printer, making it a sale of property qualifying for capital gains treatment, despite the agreement's initial 'license' label.

Facts

Petitioner Shepard invented a high-speed printer and filed patent applications related to it. NCR wanted this printer for their computers. Initially, NCR purchased two printers from Shepard. NCR and Shepard then negotiated an agreement for NCR to manufacture the printers. Shepard possessed both patents and essential technological know-how to manufacture the printer, which went beyond the patent disclosures. The agreement was drafted by NCR and labeled a 'License Agreement,' referencing Shepard's patent applications and providing for a royalty based on printer sales. Crucially, Shepard provided NCR with detailed manufacturing drawings and technical information necessary to produce the printer.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Shepard's income tax, arguing that the payments from NCR were ordinary income, not capital gains. Shepard petitioned the Tax Court, contesting this determination.

Issue(s)

1. Whether the payments received by Shepard from NCR constituted royalty payments for a nonexclusive patent license (ordinary income) or proceeds from the sale of technological know-how (capital gains)?
2. Whether Shepard transferred all substantial rights of ownership in the technological know-how to NCR, thereby qualifying the transaction as a sale for capital gains purposes?

Holding

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1. No, because the payments were primarily for the transfer of technological know-how, not patent licenses.
2. Yes, because Shepard conveyed all substantial rights in the technological know-how to NCR.

Court's Reasoning

The court determined that despite the 'License Agreement' label, the substance of the transaction was a sale of technological know-how. The court emphasized that the technology, embodied in detailed drawings and manufacturing information, was crucial for manufacturing the printer, and the patents alone were insufficient. The court noted that NCR needed the know-how to efficiently produce the printer, and this was the primary value transferred. The court highlighted that the agreement, while referencing patents, focused on delivering the technical means to manufacture the printer. The court pointed to the supplemental agreements, particularly the 'optional termination' clause, as evidence that payments were intended as full compensation for the technology. Quoting from *Warner-Lambert Pharm. Co. v. John J. Reynolds, Inc.*, the court distinguished between patent licenses with implied termination upon patent expiration and trade secrets/know-how, where payment obligations can extend indefinitely unless explicitly terminated. The court concluded that Shepard relinquished all substantial rights in the know-how, stating, "By granting NCR the freedom to use the technology as it desired indicates to us that petitioner, thereby, conveyed to NCR the freedom to disclose the technology to others and that, thereafter, such company could have prevented the unauthorized disclosure of such technology." Referencing *Tabor v. Hoffman*, the court clarified that selling products manufactured using secret processes does not automatically disclose the secrets themselves, reinforcing that Shepard's continued printer sales did not negate the transfer of know-how to NCR.

Practical Implications

Shepard v. Commissioner provides crucial guidance on distinguishing between ordinary income from patent licensing and capital gains from the sale of technology, particularly know-how. It underscores that the label of an agreement is not determinative; courts will examine the substance of the transaction. For legal practitioners, this case highlights the importance of: (1) Carefully analyzing agreements involving both patents and know-how to accurately characterize the nature of the transferred property for tax purposes. (2) Focusing on whether 'all substantial rights' in the technology, including the right to control disclosure, have been transferred to achieve capital gains treatment. (3) Recognizing that the transfer of know-how can be treated as a sale of property, even when patents are also involved, if the know-how is the primary asset transferred. This case remains relevant for structuring technology transfer agreements to optimize tax outcomes, especially in industries where proprietary know-how is as valuable as, or more valuable than, patent protection.

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