Shepard v. Commissioner, 61 T. C. 608 (1974)

Payments for technology transferred may be treated as capital gains if the transferor relinquishes all substantial rights of ownership in the technology.

Summary

Francis H. Shepard, Jr. developed a high-speed printer and entered into agreements with the National Cash Register Co. (NCR) to provide manufacturing technology and patent licenses. The issue was whether payments received from NCR were royalties or proceeds from a technology sale. The Tax Court held that these payments constituted capital gains, as Shepard transferred all substantial rights in the technology. The decision hinged on the interpretation of ambiguous agreements and the actions of the parties, emphasizing that the technology, not just the patents, was central to the transaction.

Facts

Francis H. Shepard, Jr. , a consulting engineer, developed a high-speed printer known as the Model 190 High Speed Typer. In 1955, he entered into agreements with the National Cash Register Co. (NCR), which included purchasing two typers and later, a license agreement to manufacture the typer. The agreement provided NCR with technical drawings and designs necessary to manufacture the typer, along with a nonexclusive license under Shepard's patent applications. Subsequent supplemental agreements modified the royalty structure and provided termination options. During the tax years 1965-1967, Shepard reported payments from NCR as long-term capital gains, which the IRS challenged as ordinary income.

Procedural History

The IRS issued a notice of deficiency for the taxable years 1965, 1966, and 1967, asserting that the payments Shepard received from NCR were ordinary income. Shepard petitioned the Tax Court for a redetermination of the deficiencies. The Tax Court held in favor of Shepard, determining that the payments were for the sale of technology and thus qualified as long-term capital gains.

Issue(s)

1. Whether the amounts received by Shepard from NCR during the taxable years 1965, 1966, and 1967 represented royalty payments for a nonexclusive license under patents or proceeds from the sale of technology.
2. Whether the transfer of technology constituted a sale such that the payments qualified as long-term capital gains.

Holding

1. No, because the court found that the payments were for the technology

transferred rather than a license under the patents.
2. Yes, because Shepard relinquished all substantial rights of ownership in the technology, allowing the payments to be treated as capital gains.

Court’s Reasoning

The court interpreted the agreements between Shepard and NCR, noting their ambiguity regarding whether the payments were for patents or technology. The court emphasized that the technology necessary to manufacture the typer was not fully disclosed in the patent applications, and NCR’s primary interest was in obtaining the technology. The court relied on extrinsic evidence, including the actions of the parties and testimony, to resolve this ambiguity. It was determined that Shepard conveyed all substantial rights of ownership in the technology to NCR, as evidenced by the optional termination provision in the supplemental agreement. The court also cited Tabor v. Hoffman to support the principle that selling a product does not necessarily disclose the technology used in its manufacture. The court concluded that the payments were for the technology sold and thus constituted capital gains.

Practical Implications

This decision clarifies that for payments to be treated as capital gains from the sale of technology, the transferor must relinquish all substantial rights of ownership in the technology. Legal practitioners should carefully draft technology transfer agreements to specify whether the transaction is a sale or a license, as this affects tax treatment. Businesses transferring technology should be aware that retaining rights to disclose the technology could result in payments being treated as ordinary income. Subsequent cases like United States Mineral Products Co. have applied similar reasoning in determining the nature of technology transfers. This ruling may encourage more precise contractual language in technology transactions to achieve desired tax outcomes.