Chu v. Comm'r, 58 T. C. 598 (1972)

A patent application transferred to a controlled corporation is not considered depreciable property under IRC § 1239 if it has not matured to the point of being the substantial equivalent of a patent.

Summary

In Chu v. Comm'r, the Tax Court held that the proceeds from Dr. Chu's sale of his interest in a patent application to his controlled corporation were not taxable as ordinary income under IRC § 1239. The court found that the patent application was not depreciable property because it had not matured to the point of being treated as a patent. Dr. Chu, an authority on electromagnetic theory, had developed an antenna system and assigned the patent application to Chu Associates, Inc. , which he controlled. The Tax Court emphasized the distinction between a patent and a patent application, noting that the application in question had been repeatedly rejected and thus was not the equivalent of a patent at the time of transfer.

Facts

Lan Jen Chu, an expert in electromagnetic theory, developed an antenna system and filed a patent application in 1956. In 1959, he assigned his 11/12 interest in the application to Chu Associates, Inc. , a corporation he controlled. The patent application was repeatedly rejected by the Patent Office, primarily for claims 1-13, which were the core of the invention, though claims 14-18 were deemed allowable. Chu received income from the corporation based on the sales of antennas produced under the patent, which was eventually granted in 1961. The IRS argued that the income should be taxed as ordinary income under IRC § 1239.

Procedural History

The IRS determined deficiencies in Chu's income tax for the years 1962-1965, treating the income from the patent application sale as ordinary income. Chu petitioned the Tax Court, which held that the patent application was not depreciable property under IRC § 1239 and thus the income was taxable as capital gains.

Issue(s)

1. Whether the patent application transferred by Dr. Chu to Chu Associates, Inc. was property of a character subject to the allowance for depreciation under IRC § 1239.

Holding

1. No, because the patent application had not matured to the point where it could be treated as a patent for purposes of IRC § 1239.

Court's Reasoning

The Tax Court relied on its prior decision in Estate of William F. Stahl and the Seventh Circuit's reversal of that decision in part. The court distinguished the present case from Stahl by noting that the patent application in question had been repeatedly rejected by the Patent Office, particularly for the core claims 1-13. The court found that the application had not reached the level of maturity required to be considered the equivalent of a patent under the Seventh Circuit's criteria. The court emphasized the importance of the core claims to the overall patent application and concluded that the application was not depreciable property under IRC § 1239.

Practical Implications

This decision clarifies that for a patent application to be considered depreciable property under IRC § 1239, it must have matured to the point of being treated as a patent. Tax practitioners should carefully assess the status of patent applications before advising clients on the tax treatment of their transfer to controlled corporations. The decision also highlights the importance of distinguishing between patent applications and granted patents for tax purposes. Subsequent cases have followed this distinction, and practitioners should be aware of the potential for capital gain treatment when dealing with early-stage intellectual property transfers.

