Glen O'Brien Movable Partition Co. v. Commissioner, 70 T. C. 492 (1978)

A transfer of patent rights without retaining substantial rights constitutes a sale, whereas a transfer of know-how for a limited time is considered a license.

Summary

Glen O'Brien Movable Partition Co. entered into an agreement with Yawata Econ Steel Co. , transferring Japanese patent rights and know-how for partition systems. The Tax Court held that the transfer of patent rights was a sale, entitling the company to long-term capital gains treatment, as no substantial rights were retained. However, the transfer of know-how was deemed a license due to its limited duration, resulting in ordinary income. The court allocated $10,000 of the $25,000 initial payment to the patent rights sale, with the remainder attributed to the know-how license.

Facts

Glen O'Brien Movable Partition Co. , a Missouri-based manufacturer of partition systems, entered into a Technical Services Agreement with Yawata Econ Steel Co. , a Japanese corporation, in 1970. The agreement granted Yawata exclusive rights to manufacture and sell Glen O'Brien's partition systems in Japan for six years, using Glen O'Brien's Japanese patent rights and know-how. In exchange, Yawata paid an initial $25,000 payment and agreed to future royalty payments based on sales. Glen O'Brien received the initial payment in 1970 and reported $20,000 of it as long-term capital gains from the sale of a patent. The Commissioner of Internal Revenue challenged this treatment, arguing that the payment was for services and should be taxed as ordinary income.

Procedural History

The Commissioner determined a deficiency in Glen O'Brien's federal income tax for the fiscal year ended July 31, 1971. Glen O'Brien petitioned the United States Tax Court for a redetermination of the deficiency. The Tax Court heard the case and issued its opinion on June 28, 1978, holding that the transfer of patent rights constituted a sale, while the transfer of know-how was a license.

Issue(s)

1. Whether the $25,000 payment from Yawata to Glen O'Brien was made for the transfer of Japanese patent rights and know-how?
2. Whether the transfer of Japanese patent rights to Yawata constituted a sale, entitling Glen O'Brien to long-term capital gains treatment?
3. Whether the transfer of know-how to Yawata was a sale or a license?

Holding

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1. Yes, because the payment was made in exchange for both the patent rights and the know-how as per the agreement.
2. Yes, because Glen O’Brien retained no substantial rights in the Japanese patents, making the transfer a sale under sections 1221 and 1231 of the Internal Revenue Code.
3. No, because the transfer of know-how was for a limited period of six years, indicating a license rather than a sale.

Court’s Reasoning

The court applied the legal rule that a transfer of patent rights without retaining substantial rights constitutes a sale, while a transfer of know-how for a limited time is a license. The court found that Yawata received the right to apply for Japanese patents in its own name, and Glen O’Brien retained no substantial rights in these patents, thus constituting a sale. The court relied on cases such as Waterman v. MacKenzie and Bell Intercontinental Corp. v. United States to support this conclusion. Regarding the know-how, the court interpreted the agreement’s six-year term and lack of perpetual transfer as evidence of a license. The court also considered the exclusivity and confidentiality provisions, finding that Glen O’Brien retained substantial rights in the know-how. The court allocated $10,000 of the initial payment to the patent rights sale and the remainder to the know-how license, emphasizing the burden of proof on Glen O’Brien to demonstrate the proper allocation.

Practical Implications

This decision clarifies the distinction between the sale of patent rights and the licensing of know-how for tax purposes. Practitioners should carefully draft agreements to ensure that patent rights transfers are structured as sales if capital gains treatment is desired. The case highlights the importance of the duration of the transfer and the rights retained by the transferor in determining whether a sale or license has occurred. Businesses should be aware that know-how transfers for limited periods will likely be treated as licenses, resulting in ordinary income. This ruling has been applied in subsequent cases, such as PPG Industries, Inc. v. Commissioner, to guide the tax treatment of similar intellectual property transactions.

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