Tomerlin Trust v. Commissioner, T.C. Memo. 1987-115

Whether payments received for the transfer of a trademark constitute royalty income or proceeds from the sale of an asset for the purpose of determining personal holding company tax liability depends on whether the transferor retained significant rights in the trademark, indicating a license rather than a sale.

Summary

The Tomerlin Trust, transferee of Cyclo Automotive, Inc., contested deficiencies in personal holding company tax. The central issue was whether payments Cyclo received from Accra-Pac, Inc., for the use of the "CYCLO" trademark were royalties or sale proceeds. The court determined that despite the agreement being termed a "license," it constituted a sale because Cyclo transferred all substantial rights to the trademark, retaining only limited rights for quality control and brand protection. Consequently, the income was not classified as royalty income, and Cyclo Automotive was not deemed a personal holding company.

Facts

Cyclo Automotive, Inc. (Automotive) owned the registered trademark "CYCLO" for automotive chemical products. In 1976, Automotive entered into a contract with Accra-Pac, Inc. (Accra-Pac), granting Accra-Pac exclusive worldwide rights to use the CYCLO trademark for existing and new products. Accra-Pac was to pay Automotive a per-can fee, adjusted for cost of living, with payments continuing indefinitely even after Accra-Pac potentially acquired title to the trademark upon reaching $1 million in payments. Automotive retained rights to inspect Accra-Pac's operations for quality control. Automotive dissolved in 1982, distributing the contract to its shareholders, including the petitioner, Tomerlin Trust.

Procedural History

The IRS issued a notice of deficiency to the Tomerlin Trust as transferee of Automotive, asserting personal holding company tax deficiencies for 1979-1982. The Tomerlin Trust petitioned the Tax Court, contesting the deficiency. The Tax Court addressed whether the payments from Accra-Pac to Automotive were royalties or sale proceeds, impacting Automotive's status as a personal holding company.

Issue(s)

1. Whether the payments received by Cyclo Automotive from Accra-Pac under the 1976 contract constituted royalty income within the meaning of section 543 or proceeds from the sale of an asset.
2. Whether Cyclo Automotive qualified as a personal holding company under section 541, based on the nature of the income from the trademark agreement.

Holding

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1. No, the payments received by Cyclo Automotive were proceeds from the sale of an asset, not royalty income, because Cyclo transferred all substantial rights to the trademark.
2. No, because the income was from the sale of an asset and not royalty income, Cyclo Automotive did not meet the personal holding company income test under section 542(a)(1).

Court's Reasoning

The court analyzed the 1976 contract and applied pre-section 1253 case law, as section 1253 did not define 'sale' versus 'license' for trademark transfers. The court emphasized that the substance of the agreement, not its label, determines whether a sale or license occurred. Key factors indicating a sale included: (1) the exclusive, worldwide, and perpetual grant of the trademark to Accra-Pac; (2) the mandatory transfer of title upon reaching $1 million in payments; (3) Automotive's limited termination rights (only for non-payment); (4) restrictions on Automotive's future use of the trademark and business in related products. The court deemed Automotive's retained quality control inspection right and approval for separate sale of the CYCLO business as reasonable measures to protect the trademark's value, not substantial retained rights indicative of a license. Quoting *Conde Nast Publications, Inc. v. United States*, the court recognized such rights as "no more than legitimate steps to protect the value of the trademark which was to be the source of the payments to the transferor." The court concluded that "Automotive parted with all its substantial rights, both present and future, in and to the trademark," thus constituting a sale.

Practical Implications

This case clarifies the distinction between a sale and a license of a trademark for tax purposes, particularly in the context of personal holding company tax. It highlights that courts will look beyond the terminology of an agreement to its substance to determine if a transfer of a trademark constitutes a sale or a license. Legal professionals should focus on the extent of rights retained by the transferor. Agreements that transfer exclusive and perpetual rights, with limited reservations focused on quality control and brand protection, are more likely to be classified as sales, even if payments are contingent on production or use. This distinction is crucial for determining the nature of income derived from trademark transfers and its tax implications, especially concerning personal holding company status and capital gains vs. ordinary income treatment (though section 1253 dictates ordinary income treatment in many trademark transfer scenarios regardless of sale vs license characterization for capital asset purposes).

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