1966

Taxation of Patent Transfers to a Related Partnership under Section 1235

Carl W. McKinzie

Follow this and additional works at: https://scholar.smu.edu/smulr

Recommended Citation
Carl W. McKinzie, Taxation of Patent Transfers to a Related Partnership under Section 1235, 20 SMU L.J. 352 (1966)
https://scholar.smu.edu/smulr/vol20/iss2/7

This Comment is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit http://digitalrepository.smu.edu.
TAXATION OF PATENT TRANSFERS TO A RELATED PARTNERSHIP UNDER SECTION 1235

by Carl W. McKinzie

I. INTRODUCTION

Technology and scientific progress have long been cornerstones of the American way of life and fundamental to our dynamic economy. Essential to continued progress are the inventions and know-how resulting from our ever-increasing research and development expenditures. To insure this continued progress and "to provide an incentive to inventors to contribute to the welfare of the Nation," Congress, in section 1235 of the Internal Revenue Code of 1954, sought to give "holders" of patents a tax break via capital gains treatment on the transfer of all substantial rights to their patents. Contrary to pre-1954 Code years and contrary to the treatment of other property under the 1954 Code, capital gains treatment is available under section 1235 regardless of the length of time the patent has been held and regardless of whether the payments received in consideration for the transfer take the form of royalties on a license. This favorable treatment is denied, however, whenever the transfer is made to the employer of the creator or to a transferee who is within the "related persons" provision of the section.

Whether or not capital gains treatment will be allowed when a patent transfer is made by the inventor to a partnership in which the inventor has a substantial interest is a novel question. No specific prohibition denying capital gains treatment on transfers to a "related partnership" is contained in section 1235 through its reference to section 267. This omission may have substantial import upon the type of entity to be used when the "holder" of a patent, upon its transfer, seeks to obtain the capital gains incentive provided by Congress in section 1235 and also to retain a substantial voice in exploitation of the patent or in policing its use and development. It is the purpose of this Comment to analyze, evaluate, and compare the tax consequences of employing the partnership form of conducting business in an effort to reduce the tax costs and yet maintain some control over the patent's development, exploitation and utilization.

II. HISTORICAL DEVELOPMENT OF PATENT TAXATION

A. Pre-1954 Code Years

Until 1950, the Internal Revenue Code did not explicitly prescribe the tax treatment to be accorded patents. Section 117 of the 1939 Code, relating to capital gains and losses in general, provided the principal basis for giving capital gains treatment to patent transfers. An invention could not qualify for capital gains treatment unless it was a capital asset and was sold or exchanged.

To meet the capital asset requirement, the taxpayer had to show that the patent was a capital asset under section 117(a)(1) or property used in the trade or business under section 117(j). An inventor who devoted all or a major portion of his time to developing patentable property was classified as a "professional inventor," with the result that his property was encompassed in the section 117(a)(1) prohibited category of "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The professional was therefore denied capital gains treatment on the sale of his invention. Section 117(j) would also accord capital gains treatment to sales of patents as quasi-capital assets if the patent were used in the trade or business and not held for sale to customers.

---

3 Section 117(a)(1) of the 1939 Code is substantially the same as § 1221 of the 1954 Code. Section 117(a)(1) provides in part:
   (a) Definitions.—As used in this chapter—
      (1) Capital Assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
         (A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
         (B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or real property used in his trade or business;
         (C) a copyright; a literary, musical, or artistic composition; or similar property; held by—
            (i) a taxpayer whose personal efforts created such property, or
            (ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; . . .
4 Section 117(j) of the 1939 Code covers gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business. It is substantially the same as § 1231 of the 1954 Code.
6 Spare time work outside the scope of his employment, however, might qualify the inventor for capital gains treatment. See Pike v. United States, 101 F.Supp. 100, 102 (D. Conn. 1951); Edward C. Myers, 6 T.C. 238, 266 (1946).
7 See note 4 infra.
8 See MERTENS, FEDERAL INCOME TAXATION § 22.133 (1958).
The requirement that the patent be sold or exchanged was easily met if it had been held for six months and sold for a specified sum. However, when the invention was permitted to be transferred for use in return for royalties, the Internal Revenue Service took the position that it was not "sold" or "exchanged" within the meaning of section 117(a)(4).\(^9\) The Tax Court, on the other hand, held in *Edward C. Myers*\(^10\) that where the purchase price was conditioned on the extent of use or profitability of the invention, transfer of the patent constituted a sale and was thus entitled to capital gains treatment. The Service continued to be largely unsuccessful in litigating its position,\(^11\) but persisted in its view until its final acquiescence in 1958.\(^12\)

In considering the proposed Revenue Act of 1950,\(^13\) Congress re-examined the 1939 Code as it related to the taxation of patents. The House of Representatives committee report on section 117(a) of the 1939 Code provided for the exclusion from the definition of "capital assets" all "patents; copyrights; inventions; designs; literary, musical or artistic compositions; and similar property in the hands of either the person whose personal efforts created such property or a person deriving a basis for the property, for the purpose of determining gain, from the person who created it."\(^14\) The Senate took issue with the House’s exclusion of patents and patentable property stating that "the desirability of fostering the work of such inventors outweighs the small amount of additional revenue which might be obtained under the House bill, and therefore the words 'invention,' 'patent,' and 'design' have been eliminated from this section of the bill."\(^15\) This refusal to exclude patents from the possibility of capital gains treatment was merely a forerunner of the financial inducement Congress was to provide inventors under the 1954 Code.\(^16\)

---

\(^9\) Section 117(a)(4) provides: "The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income."

\(^10\) See the Commissioner’s argument in *Edward C. Myers*, 6 T.C. 258 (1946).

\(^11\) 6 T.C. 258 (1946). The tax court held that where an inventor, who was neither a professional nor in the business of buying and selling patent rights, in consideration of certain annual payments or royalties to be paid to him, granted an exclusive license to another, to make, use, and sell an invention which he had held for more than two years, such exclusive license should be regarded for income tax purposes as a sale by the inventor of his invention and that gains thereafter derived from periodic payments under the license agreement were taxable as long term capital gains. The Commissioner at first acquiesced in the Myers decision. 1946-1 Cum. Bull. 3. This position was subsequently reversed in 1950. 1950-1 Cum. Bull. 7. For a brief discussion of these events and subsequent happenings, see note 18 infra.

\(^12\) See Joseph, *Tax Treatment of Sales and Licenses of Patents*, 32 Taxes 803 (1941).


\(^14\) 64 Stat. 906 (1950).


B. The 1954 Code

1. Section 1235 The enactment of section 1235 of the Internal Revenue Code of 1954 was designed to provide capital gains incentive to certain inventors and their financiers who formerly could not qualify for such treatment because of their professional inventor designation or because of a holding period of less than six months. Section 1235 provides that a transfer of all substantial rights to a patent, or an undivided interest therein, by a holder to transferees other than related persons shall be treated as if it were a sale or exchange of a capital asset held for more than six months without regard to whether the payments received in consideration for the transfer take the form of royalties on a license.\textsuperscript{17}

\textsuperscript{17}Section 1235. Sale or Exchange of Patents.

(a) General.—A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(1) payable periodically over a period generally coterminous with the transferee’s use of the patent, or

(2) contingent on the productivity, use, or disposition of the property transferred.

(b) “Holder” Defined.—For purposes of this section, the term “holder” means—

(1) any individual whose efforts created such property, or

(2) any other individual who has acquired his interest in such property in exchange for consideration in money or money’s worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither—

(A) the employer of such creator, nor

(B) related to such creator (within the meaning of subsection (d)).

(c) Effective Date.—This section shall be applicable with regard to any amounts received, or payments made, pursuant to a transfer described in subsection (a) in any taxable year to which this subtitle applies, regardless of the taxable year in which such transfer occurred.

(d) Related Persons.—Subsection (a) shall not apply to any transfer, directly or indirectly, between persons specified within any one of the paragraphs of section 267(b); except that, in applying section 267(b) and (c) for purposes of this section—

(1) the phrase “25 per cent or more” shall be substituted for the phrase “more than 50 per cent” each place it appears in section 267(b), and

(2) paragraph (4) of section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants.

\textsuperscript{18}In spite of the enactment of § 1235, the battle continued to rage as to whether or not the granting of an exclusive license in exchange for royalties based on the extent of use or profitability of the invention was an outright sale. The Commissioner had at first acquiesced in the principle established in the Myers case, 6 T.C. 258 (1946), that the granting of the license did constitute a sale. 1946-1 Cum. Bull. 3. Then the Commissioner withdrew his acquiescence in 1950. 1950-1 Cum. Bull. 7. Congress interceded and enacted § 1235, making it clear that the 1954 Code applied to amounts received regardless of the year in which the patent transfer occurred.

This was not dispositive of the matter, for the Internal Revenue Service announced in Rev. Rule 18, 1955-1 Cum. Bull. 97, that it would adhere to its position for years beginning after May 31, 1950, and prior to the effective date of the 1954 Code. This meant that
Though section 1235 accords special tax treatment heretofore unavailable for certain classes of inventors, many problems still remain as to its interpretation. Some of the primary areas of concern which have been the topic of various commentators and the subject of comprehensive litigation include: what constitutes a sale of all substantial rights to a patent; who may be the holder of a patent; and who constitutes a related person within the meaning of the section.

2. General Capital Gains Provisions Inventors who, for any reason, cannot qualify under section 1235 are not precluded from securing capital gains under the general capital gains provisions of the 1954 Code. This is made abundantly clear by the Senate committee's report stating that the committee, in enacting section 1235, "has no intention of affecting the operation of existing law in those areas without its scope. For example, the tax consequences of the sale of patents . . . by individuals who fail to qualify as 'holders,' or by corporations, is to be governed by the provisions of existing law as if this section had not been enacted."

Under section 1221 of the 1954 Code, as under section 117 (a) of the 1939 Code, an inventor can qualify for capital gains treatment if the patent has been held for investment for six months. Capital gains are also available under section 1231, as formerly under section 117 (j) if a patent held for six months is used in the taxpayer's business and the taxpayer is not engaged in the business of selling patents. These general provisions will continue to preclude the pro-

---

21 For a discussion of substantial rights, employer-employee relationships, number of rights retained, and related persons, see Mortenson, Patent Royalties—Capital Gain or Ordinary Income, 36 Taxes 787 (1958).
23 The term "capital asset" is defined at length by § 1221 of the 1954 Code. It means property held by the taxpayer that does not fall into certain excluded categories (e.g., property held for sale to customers in the ordinary course of the taxpayer's business; certain accounts receivable; a copyright, a literary, musical, or artistic composition; etc.)
24 See note 3 supra.
25 Section 1231, giving special status to gains and losses from certain types of property depending upon whether a net gain or a net loss is realized for the taxable year, is identical in principle and in most details with § 117(j) of the 1939 Code.
26 See note 4 supra.
fessional inventor from achieving capital gains benefits unless he can bring himself within the provisions of section 1235.\textsuperscript{27}

III. RELATED PERSONS PROVISIONS

To qualify for capital gains treatment on a patent transfer under either the specific provisions of section 1235 or the general provisions of sections 1221 or 1231, Congress has indicated that the transfer is not to be made within essentially the same economic group.\textsuperscript{28} To guard against such transfers, provisions have been promulgated to provide for treatment other than capital gains if the sale or exchange is between related persons.

A. General Provisions

Transactions between related taxpayers are generally covered by the following sections: section 267\textsuperscript{29} which covers losses, expenses, and interest with respect to transactions between related taxpayers; section 707\textsuperscript{30} which covers transactions between a partner and his partnership, or between related partnerships; and section 1239\textsuperscript{31} which covers gains resulting from the sale of depreciable property between spouses or between an individual and a controlled corporation. Any transfer of a patent which cannot meet the specific provisions of section 1235 falls subject to these general provisions, and, of course, section 1235 incorporates a slightly modified section 267 into its own provisions.

1. Section 267  Section 267 of the 1954 Code provides that even if a sale or exchange is bona fide and made in the ordinary course of business no loss deduction will be allowed if the sale or exchange is between specified related taxpayers.\textsuperscript{32} The loss deduction is denied if the

\textsuperscript{27} Aside from the related persons limitations specified in §§ 707, 267, and 1239, the limitations of §§ 1245 and 1249 should be noted. Section 1245 of the 1954 Code treats gain on the sale or exchange of a patent as ordinary income to the extent of excess depreciation taken on the property since 1961. Section 1249 treats as ordinary income the gain from the sales of patents to controlled foreign corporations after December 31, 1962. Control is there defined as the possession of fifty per cent of the combined voting power of the voting stock of the foreign corporation.

\textsuperscript{28} See notes 68 and 90 infra and accompanying text.

\textsuperscript{29} INT. REV. CODE OF 1954, § 267.

\textsuperscript{30} INT. REV. CODE OF 1954, § 707.

\textsuperscript{31} INT. REV. CODE OF 1954, § 1239.

\textsuperscript{32} Section 267(b) provides:

(b) Relationships.—The persons referred to in subsection (a) are:

(1) Members of a family, as defined in subsection (c)(4);

(2) An individual and a corporation more than 50 per cent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(3) Two corporations more than 50 per cent in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same
taxpayers are members of the same family. The family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.\(^3\) Except in cases of distribution in liquidation, a deduction is denied either party to a sale or exchange between a corporation and an individual who owns more than fifty per cent in value\(^4\) of the corporation's outstanding stock. Ownership of the outstanding stock may be either actual or constructive.\(^5\) Therefore, several persons may each own more than fifty per cent in value of a corporation's outstanding stock.\(^6\) The prohibition also applies to transactions between corporations more than fifty per cent in value\(^7\) owned, directly or indirectly, by the same individual, if either one of the corporations was a personal holding company or a foreign personal holding company.\(^8\) The section also prohibits a loss deduction to either party from a sale or exchange between the following parties to a trust: a trust and a grantor of that trust; a trust and another trust having the same grantor; a trust and the beneficiary of that trust; a trust and the beneficiary of another trust having the same grantor; and a trust and a corporation more than

\(^3\) Int. Rev. Code of 1914, § 267(c)(4). The loss prohibition does not extend to sales to relatives who are not members of the taxpayer's family as that term is defined in § 267(c)(4). For example, a deduction has been allowed on a sale to sons-in-law of the taxpayer's brother. Maurice B. Saul, 6 CCH Tax. Ct. Mem. 734 (1947). The prohibition does not extend to losses on sales by a husband to members of his wife's family, even though such losses are claimed on a joint return. J. Henry DeBoer, 16 T.C. 662 (1951), aff'd, 194 F.2d 289 (2d Cir. 1952).

\(^4\) This limitation apparently does not prevent the transferor and the prohibited relatives from having voting control so long as the value of their stock is less than 25\%. Therefore, it may be highly desirable to utilize both voting and non-voting stock. See Bailey, Disposition of Inventions, N.Y.U. 19th Inst. on Fed. Tax 89 (1961).

\(^5\) Int. Rev. Code of 1914, § 267(c).

\(^6\) E.g., Hosch Bros. Co., 3 T.C. 279 (1944); see note 108 infra and accompanying text, where each of four brothers were held to have 100\% ownership in a partnership. See note 34 supra.

\(^7\) This prohibition apparently does not apply where the individual owning more than 10\% of the stock of the purchasing corporation owned less than 10\% of the stock of the selling corporation. Sheldon Land Co., 42 B.T.A. 498 (1940).
fifty per cent owned, directly or indirectly, by or for that trust or by or for its grantor.\textsuperscript{39} The other transaction under section 267 which denies a loss deduction is a sale or exchange to an exempt corporation or organization by a person in control of that corporation or organization.\textsuperscript{40}

Since the "relationships" provisions of section 267 do not include members of a partnership and the partnership as related persons, the regulations under section 267 take the position that transactions between partners and partnerships are beyond the scope of the section.\textsuperscript{41}

These regulations refer to section 707 as the governing provision for such transactions and recognize that for purposes of section 707, the partnership is considered to be an entity separate from the partners.\textsuperscript{42}

The regulations provide, however, that

any transaction described in section 267(a) between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately. Therefore, if the other person and a partner are within any one of the relationships specified in section 267(b), no deduction with respect to such transactions between the other person and the partnership shall be allowed—

(i) To the related partner to the extent of his distributive share of partnership deductions for losses or unpaid expenses or interest resulting from such transactions, and

(ii) To the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of such transaction.\textsuperscript{43}

However, in Commissioner v. Whitney,\textsuperscript{44} the thirteen members of a partnership, pursuant to a plan to incorporate the partnership, transferred securities to the corporation for cash and the assumption of the partnership liabilities. The members collectively owned more than fifty per cent in value of the outstanding shares of the corporation. The Second Circuit held that the loss on the sale of the securities

\textsuperscript{39} INT. REV. CODE OF 1954, § 267(b) (4)-(8); §§ 267(b) (7), (8), and (9) are new in the 1954 Code and apply only to sales and exchanges made after 1953.

\textsuperscript{40} INT. REV. CODE OF 1954, § 267(b) (9).

\textsuperscript{41} Treas. Reg. § 1.267(b)-1 (b) (1954).

\textsuperscript{42} Treas. Reg. § 1.267(b)-1(b) (1) (1954). The regulation provides, in part:

(b) Partnerships. (1) Since section 267 does not include members of a partnership and the partnership as related persons, transactions between partners and partnerships do not come within the scope of section 267. Such transactions are governed by section 707 for the purposes of which the partnership is considered to be an entity separate from the partners.

\textsuperscript{43} Ibid. Examples are cited in Treas. Reg. § 1.267(b)-1(b) (2) (1954) in explanation of Treas. Reg. § 1.267(b)-1(b) (1).

\textsuperscript{44} 169 F.2d 162 (2d Cir. 1948), cert. denied, 335 U.S. 892 (1948).
by the partnership to the corporation should be disallowed under the predecessor to section 267. Each partner was found to own more than fifty per cent of the corporation's stock because each partner was considered to be the constructive owner of the stock held by his partners.

2. Section 707

The sections of the 1939 Code relating to partners and partnerships provided only a bare outline which was filled in, if at all, by case law and administrative practice. The more detailed provisions of the 1954 Code relating to partnerships contain section 707 especially relating to transactions between a partner and his partnership which had no counterpart under the 1939 Code. This section generally provides that a partner who engages in a transaction with his partnership, except as a member of the firm, is treated as though he were an outsider. While both houses of Congress, in considering section 707, made clear that the "entity" approach was being utilized, they recognized that the "aggregate" theory of partnerships was more appropriate to other sections.

Both the House provisions and the Senate amendment provide for the use of the "entity" approach in the treatment of the transactions between a partner and a partnership which are described above. No reference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions.

Exceptions to the general rule that a partner is treated as an outsider apply to a sale or exchange of property between a partner and his firm if the partner owns a large interest in the partnership, or between two partnerships with a certain percentage of common ownership. Section 707(b)(1) disallows a deduction for losses in the

---

46 See also Fritz Busche, 23 T.C. 709 (1955), aff'd, 229 F.2d 437 (5th Cir. 1956).
50 Section 707(a) of the Code provides: "(a) Partner Not Acting in Capacity as Partner. — If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner."
52 [Section 707(b)(1)] Losses disallowed.—No deduction shall be allowed in respect of losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between—
   (A) a partnership and a partner owning, directly or indirectly, more
case of a sale or exchange of property, directly or indirectly, between a partnership and a person owning an interest of more than fifty per cent in capital or profits of the partnership. This disallowance also occurs where the sale or exchange is between two partnerships in which the same persons have an interest of more than fifty per cent in the capital or profits.

Section 707(b)(2) treats gains on the sale or exchange of property between a partnership and a person having an interest of more than eighty per cent in partnership capital or profits, or between two partnerships in which the same persons have an interest of more than eighty per cent in partnership capital or profits, as property other than a capital asset.

These provisions are designed to eliminate sales made for the purpose of realizing losses or achieving capital gains without a partner actually giving up economic control of the property. In determining whether a partner has an interest of more than fifty per cent in the partnership capital or profits for purposes of loss, and of more than eighty per cent for purposes of gain, the ownership rules of section 267(c) are applicable.

3. Section 1239
Section 1239 of the 1954 Code is to be contrasted with the section 707(b)(2) partnership provision on gain. Section 1239 is applicable only to sales to a controlled corporation of depreciable property (e.g. patents), whereas under section 707(b)(2) ordinary income results from the sale of other property as well.
Section 12397 denies capital gains treatment on certain sales or exchanges of depreciable property between a husband and wife, or between an individual and his controlled corporation. A corporation is controlled when more than eighty per cent in value8 of all outstanding stock of the corporation is beneficially owned by the taxpayer, his spouse, and his minor children and minor grandchildren.9

B. Related Persons Provision Of Section 1235(d)

To qualify for capital gains treatment on the transfer of a patent under section 1235(a), the transfer must be made by a "holder." A holder is defined in section 1235(b) as, inter alia, an individual who is neither the employer of the creator of the patent nor related to such creator within the meaning of subsection 1235(d). The related persons provision provides that capital gains shall not be available to any transfer, directly or indirectly, between persons specified within any one of the paragraphs of section 267(b). Section 1235 does alter, however, the percentage requirement needed for control of a corporation and limits the relatives who have to be included in the family of the individual. The fifty per cent in value of the outstanding stock required to constitute control of a corporation under section 267(b) is reduced to a much more onerous twenty-five per cent in section 1235. This is to be contrasted with the eighty per cent control of corporations under section 1239 and eighty per cent

7 See note 34 supra.
8 See INT. REV. CODE OF 1954, § 1239(a) (2) and Treas. Reg. § 1.1239-1 (1954).
10 See INT. REV. CODE OF 1954, § 1235(b).
11 See INT. REV. CODE OF 1954, § 1235(d).
12 See notes 32-46 supra and accompanying text.
13 INT. REV. CODE OF 1954, § 1235(d) (1). As originally enacted, § 1235(d) also provided for 30% in value of outstanding stock to constitute control. The reduction to 25% was made by H.R. REP. No. 775, 85th Cong., 1st Sess. 33 (1957):
In view of the especially favorable nature of the capital gains treatment provided under section 1235, your committee believes that this 50 per cent test is too high, and that capital gains treatment on the sale by an inventor of his rights in a patent should not be available under this section in any case where he owns 25 per cent or more of the stock of the corporation. For that reason the bill provides that in applying the rules under section 267(b) the phrase "25 per cent or more" is to be substituted for the phrase "more than 50 per cent" each time it appears.
14 See note 57 supra and accompanying text.
control of partnerships under section 707 when gain results.

In contrast with the more stringent control of corporations is the laxation of what constitutes the family of an individual under section 267. Whereas section 267(c) defines a family so as to include brothers and sisters, spouse, ancestors, and lineal descendants, section 1235(d)(2) provides that the family of an individual shall include only his spouse, ancestors, and lineal descendants, thus eliminating brothers and sisters.77

The legislative history of the related taxpayer’s definition indicates that the section 1235(d) limitation was designed to “prevent possible abuses arising from the sale of patents within essentially the same economic group.”78 No specific prohibition is contained, however, within section 1235(d), nor within the incorporated section 267(b) as to transfers between a partner and his controlled partnership or between two controlled partnerships.

The omission of a specific reference to partnerships has given rise to considerable difficulty of interpretation. It would seem clear that neither a corporation nor a partnership can be a “holder” under section 1235(b), for that section expressly defines a holder as an individual who either invented the patent or purchased an interest in it before it was reduced to actual practice.79 The regulations adopt this view as to partnerships.80 The difficulty of interpretation arises in determining whether or not the transferee may be a controlled partnership. It is statutorily provided81 that a twenty-five per cent controlled transferee corporation cannot be the vehicle for capital gains on the transfer, but the statute is silent as to a transferee partnership. The legislative purpose of preventing capital gains treatment on the sale of patents within essentially the same economic group77 would perhaps be abused if the partnership limitation is not read into the statute; yet there would seem to be very little authority for doing so.

76 See note 53 supra and accompanying text.
80 Treas. Reg., § 1.1235-2(d)(2) (1954), provides, in part: “Although a partnership cannot be a holder, each member of a partnership who is an individual may qualify as a holder as to his share of a patent owned by the partnership.” (Emphasis added.)
81 INT. REV. CODE OF 1954, § 1235(d).
82 See note 68 supra and accompanying text.
IV. CASES CONSTRUING PATENT TRANSFERS TO A RELATED PARTNERSHIP

A. Weller v. Brownell

Very few cases have litigated whether or not a patent transfer by a partner or partnership to a "controlled" partnership will qualify for the capital gains treatment permitted under section 1235. In Weller v. Brownell, taxpayer Weller developed a new type of soldering gun in 1941, on which a patent was issued in 1946. Prior to the issuance of the patent, Weller, his wife, and several brothers joined in the formation of a general partnership to develop and market the invention. Weller was to receive royalties on sales for a five year period in return for his assignment of the patent to the partnership. In 1949, a limited partnership was formed in which Weller, his wife, a brother, and another person were general partners, with another brother, the brother's wife, and another outsider as limited partners. Difficulty was experienced over transferring the patent from the general partnership to the limited partnership because of title questions caused by apparent infringement.

To clear title, a reissue patent application was filed, and, in 1952, the general partnership assigned the full title to the patent to Weller who immediately assigned the full title to the limited partnership. The patent reissue was granted in 1953, and Weller negotiated a new royalty agreement. The 1955-57 proceeds from this royalty agreement, Weller contended, should be accorded capital gains treatment under section 1235.

In considering whether or not capital gains were available to the extent that the transfer of the patent rights were made to a partnership of which Weller and his wife were partners, the court found that Weller was a "holder" within the meaning of section 1235 of the 1954 Code. Weller contended that the limited partnership to which he transferred his patent rights in 1952 must be treated under section 707(a) as a separate entity from the partners of which it was composed and, therefore, the partnership would not come within the prohibited class of transferees set forth in section 1235(d). The government met this contention by asserting that the transfer occurred prior to the effective date of section 707, and, therefore, under the
"aggregate" theory of partnerships, the sale must be considered as a sale to the individual partners. Because Weller and his wife each owned 22.45 per cent interest in the partnership, the government contended that 44.90 per cent of the transfer could not be considered a sale or exchange of a capital asset due to the restriction contained in section 117(q) of the 1939 Code which was also included in section 1235 of the 1954 Code.

The court determined that "gains realized by the plaintiffs subsequent to the enactment of the 1954 Code should be governed by it." The court concluded that payments received in 1955-57 from the 1952 transfer should be governed by the 1954 Code, and noted that

section 707(a) of that Code provides that when a partner engages in a transaction with the partnership, the transaction should be considered as occurring between the partnership and one who is not a partner. Therefore, the payments received by Carl and Emily Weller since the enactment of the 1954 Code should be treated as capital gains under section 1235.87

The court goes outside section 1235 to apply the entity concept of section 707. In thus relying on section 707, the court was able to find that the provisions of section 1235 had been complied with, entitling the inventor to capital gains treatment. From the decision in this case, it would appear that an inventor may be able to achieve section 1235 capital gains treatment upon a transfer to a partnership in which he has an interest. Query as to whether the court would have permitted capital gains had the interest been substantially greater than 44.90 per cent?88

B. Burde v. Commissioner

In Burde v. Commissioner89 the inventor of a bath oil formula sought to interest two business associates (taxpayers) in the formula which he had conceived but had not begun to develop. The proposal was accepted, and a one-third interest in the formula was transferred to each of the two taxpayers in consideration for their agreement to finance all of the development costs. Following successful development of the formula, the two taxpayers, in an arm's length

---

87 The Third Circuit had held, under the 1939 Code, that a partnership was not separate from its partners and did not own property as an entity distinct from its partners. Randolph Products Co. v. Manning, 176 F.2d 190 (3d Cir. 1949).
88 See note 18 supra.
89 240 F.Supp. at 209.
90 Id. at 210.
91 The wife's 22.45% interest is attributable to Weller as well as his own interest of 22.45%.
transaction, transferred their interests in the formula to a manufacturing partnership consisting of the inventor of the formula and the two wives of the taxpayers, with both wives and the inventor each having a one-third interest. The taxpayer-husbands and the inventor received a royalty on net sales in consideration for the transfer of their interest in the formula to the partnership. The taxpayer-husbands in 1958 each received payments of $19,484.33 pursuant to this arrangement. This amount was reported as a long-term capital gain under section 1235. The Commissioner assessed a deficiency, asserting that the transfer from the two husbands and the inventor to a partnership consisting of the two wives and the inventor was between related persons, and that the royalty payments should therefore be taxed as ordinary income.

The Tax Court\(^1\) sustained the Commissioner, holding that a partnership can never be treated as an entity for purposes of section 1235. The taxpayers were deemed to have transferred their respective interests in the invention to their wives who, the Tax Court said, were related persons within the meaning of section 267(b) and (c).\(^2\) In determining that a partnership could not be treated as an entity for purposes of section 1235, the court relied on George N. Soffron.\(^3\) In that case, the tax court upheld regulation 1.1235-2(d) (2)\(^4\) which provides that for purposes of section 1235, a partnership cannot be a holder of a patent, but each individual member of the partnership must be regarded as the holder of his share of the patent owned by the partnership. Even had the transfer to the partnership satisfied the literal requirements of section 1235, the Tax Court found that capital gains would have been defeated under section 707(b) (2) (B)\(^5\) of the 1954 Code.

On appeal, the Second Circuit explicitly rejected the Tax Court's holding that a partnership could never be treated as an entity for purposes of section 1235.\(^6\) The taxpayers' argument that the failure of section 267(b) to define a partnership as a related person made section 1235(d) inapplicable to the case was also rejected. The Second Circuit found the Tax Court's reliance on regulation 1.1235-2(d) (2) to be misplaced. It noted that a partnership cannot be the

---

\(^{1}\) T.C. 252 (1964).

\(^{2}\) Id. at 262.

\(^{3}\) T.C. 787 (1961). See notes 102-08 infra and accompanying text.

\(^{4}\) See note 67 supra and accompanying text.

\(^{5}\) See note 53 supra.

\(^{6}\) 352 F.2d at 996: "We affirm, but we disagree with one of the alternative grounds relied on below—that a partnership can never be treated as an entity for purposes of section 1235."
holder of a patent.\textsuperscript{87} The court also noted that a transfeere of an invention which has been reduced to actual practice\textsuperscript{88} can never be a holder. Therefore, the regulation interpreting the statutory definition of holder has no relevance to a transferee partnership, and nothing in section 1235 precludes treating the partnership as an entity.\textsuperscript{89}

The court noted that the silence of section 267 (b) on the subject of partnerships did not necessarily manifest a congressional intent to exclude transfers to partnerships from the ambit of section 1235 (d). The court thought it far more likely that Congress never considered the question. This construction was held to be in keeping with the legislative history\textsuperscript{90} of 1235 (d) that capital gains are not to be accorded transfers within essentially the same economic group and with the congressional recognition\textsuperscript{91} in section 707 that the aggregate concept of a partnership might be appropriate in applying other provisions. It was not necessary, however, to "pierce the partnership veil"\textsuperscript{92} in all section 1235 cases. Doing so would disqualify, for capital gains treatment, to the extent of the transferor's interest in the partnership, a patent transfer to a partnership in which the transferor had even a minute interest. The court relied on Weller v. Brownell\textsuperscript{93} to support the proposition that the partnership veil need not necessarily be pierced.

The Second Circuit concluded, however, that the test employed in section 707 to determine when a partnership may be treated as an entity was highly relevant, and perhaps controlling, in an analysis of the same question arising under section 1235.\textsuperscript{94} A controlled partnership is not to be treated as a separate entity for purposes of section 707 but is instead to be treated as an aggregate of individuals. The control provisions of sections 707 (b) (2) and 1235 (d), being designed to accomplish the same purpose, should thus be compatible in determining if a partnership is to be treated as an entity. The court was careful to point out that the taxpayer need not necessarily satisfy both sections 707 and 1235; rather, it suggested that "in

\textsuperscript{87} Section 1235 (b) expressly defines a holder as an individual who either invented the invention or purchased an interest in it before it was reduced to actual practice. See note 70 supra.

\textsuperscript{88} \textit{Int. Rev. Code of 1954}, § 1235 (b). An invention is reduced to actual practice when it has been tested and operated successfully under operating conditions. Treas. Reg. § 1.1235-2(e) (1954).

\textsuperscript{89} 352 F.2d at 999.


\textsuperscript{92} 352 F.2d at 999.

\textsuperscript{93} 240 F. Supp. 201 (M.D. Pa. 1965). See notes 73-79 supra and accompanying text.

\textsuperscript{94} 252 F.2d at 1000.
determining whether a transaction qualifies under section 1235, it is appropriate to examine whether it filters through the section 707 sieve.\textsuperscript{95}

Noting the possible loophole contained in section 707 whereby individuals, who as a group own most of the transferee partnership interests though no single individual and related persons own more than eighty per cent, can achieve capital gains treatment,\textsuperscript{96} the court found the activities of the inventor and the husbands constituted a joint venture, treated under tax law as a partnership.\textsuperscript{97} Thus, the transfer occurred between a partnership consisting of the inventor and the two husbands to a partnership in which they controlled an eighty per cent interest.\textsuperscript{98} On this basis, the Second Circuit affirmed the ordinary income holding of the Tax Court.\textsuperscript{99}

Judge Friendly concurred in the majority’s result but would not have applied section 707 provisions to construe related persons under section 1235 (d). He noted that section 267(b) referred to by section 1235(d) originally disqualified for capital gains treatment transfers of patents to corporations when more than fifty per cent of the stock was owned by the transferor. This provision was further tightened in 1958 to exclude transactions when the transferor held a twenty-five per cent or greater interest in the corporation.\textsuperscript{100} Despite the absence of any similar mention of partnerships in section 267(b), he would question the standard established by the majority which permits capital gains treatment on a transfer to a partnership unless more than eighty per cent is owned by the transferor, although retention of a twenty-five per cent interest in a corporation would defeat the special section 1235 benefits. Judge Friendly would have upheld the Commissioner and disregard the partnership entity completely in section 1235 situations. “[T]reating the partnership as a collection of individuals is ‘appropriate’ for fulfilling the pur-

\textsuperscript{95}Ibid.
\textsuperscript{96}Section 707(b) (2) (A) precludes capital gains treatment for a transfer by a single partner and related persons who own more than 80% of the transferee partnership interest. Section 707(b) (2) (B) mandates the same result for a transfer between two partnerships under 80% common ownership. There is no provision in § 707(b) (2) relating to a transfer by individuals who, as a group, own most of the transferee partnership, although no single individual and related persons own more than 80%. Thus, if the inventor and the two taxpayer-husbands could have successfully maintained that they were mere co-owners, they presumably might have escaped the controlled partnership provisions of § 707(b) (2) thereby achieving capital gains treatment.
\textsuperscript{97}See Int. Rev. Code of 1914, § 761.
\textsuperscript{98}Under § 267(b) (1) and (c) (4), the interest owned in the transferee partnership by the wives was attributable to the husbands.
\textsuperscript{99}The taxpayers were not eligible for capital gains treatment under the general capital gains provisions of the 1954 Code, for they had not held the patent six months prior to its sale. See 252 T.C. at 269.
\textsuperscript{100}See note 64 supra.
pose of section 1235(d) to prevent abuses from sales of patents within the same economic group.\textsuperscript{101}

C. \textit{Soffron v. Commissioner}

By way of a caveat in the \textit{Burde} case, the Second Circuit noted that the Commissioner has the specific authority to block capital gains treatment unless "all substantial rights to a patent"\textsuperscript{102} are transferred. This was not a contested point in the \textit{Burde} case. However, in \textit{George N. Soffron}\textsuperscript{103} it was held that a transfer of a patent owned in equal shares by four brothers to a partnership in which they owned equal interests did not qualify under section 1235(a) because there was no transfer of "all substantial rights." In order to ascertain if there had been a sale of all substantial rights, the court stated that "it is often necessary to cast aside the superficial indicia of the transfer and reach the core of the transaction to view its true economic realities."\textsuperscript{104} The court noted that a partnership cannot be the "holder" of a patent and thus cannot qualify for capital gains treatment. However, each member of the partnership may qualify as a holder as to his share of a patent owned by the partnership.\textsuperscript{105}

Considering the status of a partner under section 1235 in relation to this situation, the Tax Court found that both before and after the transfer, the brothers were "holders" of a one-fourth interest in the patent.

Before the transfer each petitioner was the owner of an undivided one-fourth interest as an individual and after the transfer each was deemed to own a one-fourth interest in the patent as a result of his one-fourth interest in the partnership. We are unable to detect a transfer of "all substantial rights" to the patent by the petitioners insomuch as the transfer did not effect any substantial change in their positions insofar as section 1235 is concerned. We think an examination of all the attendant facts with a view to the economic realities of the transaction definitely establishes that the assignment was a formalistic attempt to come within the purview of section 1235 in order to transform a portion of the partnership income into capital gains, while, at the same time, retaining control of the patent within the same economic group. Accordingly, it does not qualify under section 1235.\textsuperscript{106}

\textsuperscript{101} 32 F.2d at 1004.
\textsuperscript{102} \textit{I. R. Code of 1954, § 1235(d)}. The substantial rights secured by a patent are: (1) to make, (2) to use, and (3) to sell the patented article or device for the entire life of the patent. If any one, or a part of any one, or more of these three substantial rights are retained by the patentee after the execution of a particular contract, such a contract is not a sale. \textit{Buckley v. Frank}, 57-1 U.S. Tax Cas. § 9525 (W.D. Wash. 1917).
\textsuperscript{103} 35 T.C. 787 (1961).
\textsuperscript{104} \textit{Id.} at 789.
\textsuperscript{105} \textit{Treas. Reg. § 1.1235-2(d)(2)} (1954).
\textsuperscript{106} 35 T.C. at 789-90.
Failure to qualify under section 1235 for capital gains treatment rendered section 707 applicable. Section 707(b)(3)\textsuperscript{107} refers to the rules for constructive ownership of stock of section 267(c). Under that provision, the taxpayers, as brothers, were each deemed to hold a one hundred per cent interest in the partnership.\textsuperscript{108} Therefore, under section 707, the amounts realized on the exchange constituted ordinary income.

V. Analysis

It is a general proposition of law that a specific provision of a statute will take precedence over a general provision.\textsuperscript{109} The Second Circuit in \textit{Burde} determined, however, that it was appropriate to refer to the general partnership provision of section 707 to ascertain whether a patent transfer was entitled to capital gains treatment under the specific provision of section 1235. It should be noted that in the \textit{Soffron} case, the specific provisions of section 1235 were found to be inapplicable before the more general provisions of section 707 were applied. Note, however, that in the \textit{Weller} case, the taxpayer relied on the entity theory of section 707 in order to bring his patent transfer within section 1235. This was sustained by the court.

Applying the partnership control tests of section 707(b)(2), however, leads to a great divergence in treatment for partnerships as opposed to corporations. If a partnership is to be the transferee in a section 1235 transaction, the transferor can have a related interest of as high as eighty per cent.\textsuperscript{110} If the same section 1235 transaction is consummated, but with a corporation as transferee, the transferor must own less than twenty-five per cent in value of the outstanding stock of the corporation.\textsuperscript{111} Therefore, the transferor can obtain far greater control of the business vehicle which is to exploit his invention if he utilizes the partnership form.\textsuperscript{112}

In taking advantage of the partnership form to exploit the patent,
questions can arise as to appropriate taxation of royalty payments if the partnership is subsequently incorporated. Clearly, if the subsequent incorporation is primarily for the purpose of tax avoidance or is merely "a step" in the total transaction, the Internal Revenue Service will be justified in looking beyond the form and to the substance of the transaction. This is assuming, of course, that the inventor had twenty-five per cent or more but less than eighty per cent control of both the partnership and the corporation which evolved from it. The result will be treatment other than capital gains for all payments received from both the corporation and the partnership. Less clear, however, is the case where bona fide business purposes motivate the change from partnership to corporate form. All payments received prior to the incorporation will be entitled to capital gains treatment, assuming all other section 1235 prerequisites are met. Query as to the tax result to the inventor after the incorporation? The Internal Revenue Service would likely contend that all royalty payments received from the corporation are subject to ordinary income treatment. The Service will look to the controlled entity making the royalty payments. Finding a corporation in which the inventor holds stock with a value in excess of twenty-five per cent of the total outstanding shares, it will likely conclude that the royalty payments to the inventor are forbidden capital gains treatment by the express provisions of section 1235(d). The taxpayer would have availed himself of capital gains treatment provided by the corporate-partnership disparity in percentage control upon initially transferring the patent to a partnership, and the Service can readily contend that a subsequent incorporation should reverse the disparity in the government's favor. This argument is given added import when it is recognized that the taxpayer's role in the incorporation was likely significant.

On the other hand, the taxpayer may argue that the partnership

114 The rule of substance versus form has been stated by the Supreme Court in Weiss v. Stearn, 265 U.S. 242, 254 (1924), as follows:

Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of substance and not mere form.

Application of this rule is often called for in reorganizations and in transactions involving several steps.

114 The rule may be illustrated by the following example. Assume that a holder transfers a patent to a partnership in which he has a 75% interest. Royalty payments subsequently made to the holder will be accorded capital gains treatment under § 1235, the transfer having filtered through the § 707 sieve. Had the transfer been made, however, to a corporation in which the transferor held a 75% interest, the subsequent royalty payments would not have been accorded capital gains treatment under § 1235. The problem arises when the patent is transferred initially to the partnership, and the partnership is subsequently incorporated for business motivated purposes.
acted as an entity completely separate and apart from the individuals who composed it, and, as such, the incorporation would in no way affect the capital gains treatment to be accorded the inventor on receipt of royalty payments. If the partnership had granted a license to a controlled corporation to exploit the patent, the payments made from the corporation to the partnership would be ordinary income to the partnership. Since, however, the taxpayer looked solely to the partnership for his royalty payments, he should still be accorded capital gains treatment. Therefore, argues the taxpayer, why should a partnership, incorporated for legitimate business purposes, change the tax character of the royalty payments made to the inventor.

A partnership which holds a patent cannot achieve capital gains treatment as an entity on the patent's sale or exchange because it cannot qualify as a holder under section 1235. However, each member of the partnership who is an individual may qualify as a holder as to his share of the patent owned by the partnership. The wording of section 1235(b) and the regulations thereunder thus clearly limit a "holder" to an individual, thereby excluding as holders both corporations and partnerships as entities. That a corporation can be a transferee is made statutorily clear in section 1235(d) by the twenty-five per cent corporate control limitation. The Second Circuit's rationale in the Burde case that exclusion as a holder does not, of itself, prevent the transferee from being a partnership would appear most logical. Therefore, if the transferor can qualify as a holder, nothing would seem to prevent capital gains treatment on a sale or exchange to a "non-controlled" partnership.

The possibility also exists that certain individuals co-owning a patent can escape the section 707(b)(2) control provisions if they do not constitute a partnership for tax purposes. This is the section 707 loophole mentioned in the Burde case. Section 707(b)(2) precludes capital gains treatment for a transfer by a single partner and related persons who own more than eighty per cent of the transferee partnership or between two partnerships under eighty per cent common ownership. The court stated in Burde that "there is no provision in section 707(b)(2) relating to a transfer by individuals who as a group own most of the transferee partnership interests, although no single individual and related persons own more than eighty per cent." Therefore, if the transferee partnership is to be treated as

---

111 Treas. Reg. § 1.1235-2(d)(2) (1954); see note 70 supra.
116 352 F.2d at 998-99.
117 Id. at 1000-01.
118 See note 96 supra and accompanying text.
119 352 F.2d at 1001.
an entity for purposes of section 1235 as held in *Weller v. Brownell*, and the transferors have escaped, via the loophole, the 707 control provisions, the transferors arguably have qualified for capital gains treatment. However, as the court noted in *Burde*, "it is always open to the Commissioner to assess deficiencies on the ground that regardless of regularity of form as a matter of plutological reality, there was no substantial change in economic ownership."

There also exists the hazard of the *Soffron* case that there has not been a sale or exchange of "all substantial rights to a patent." In an effort to avoid the pitfalls of this case, it would seem advisable to make certain that the transferors and related persons do not own identical or substantially identical interests in the transferee after the transfer as they owned in the patent before the transfer. This hazard would apparently be avoided by injecting some new non-related persons into the ownership of the transferee.

A further suggestion previously mentioned for achieving capital gains treatment when the transfer is made to a corporation, is to utilize two classes of stock, voting and non-voting. This enables the "holder" to retain control of the transferee corporation by way of the voting stock without owning the prohibited percentage in the total value of the outstanding shares. This is made possible by the statutory language that ownership of no more than twenty-five per cent in value of the outstanding stock of the corporation will not constitute control. In designing such a transaction, it should be remembered that the voting rights will give added value to the voting stock. This will influence the proportion of voting stock which can be granted to the holder.

VI. Conclusion

In conclusion, it is to be noted that possibilities exist for achieving capital gains treatment by use of a partnership vehicle in a section 1235 patent transfer. The transfer can be constructed so as to allow the holder to retain a substantial voice in the exploitation of the patent. The sale or exchange must be carefully framed, however, to avoid the many hazards which lurk for the unwary. Legislation, or at least guidelines by the Commissioner, should be forthcoming to make more compatible the tax treatment of corporations and partnerships.

---

120 See notes 73-79 supra and accompanying text.
122 See notes 102-08 supra and accompanying text.
123 See note 34 supra and accompanying text.