

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 188

August 30, 1956

CAPITAL GAINS: LICENSE OF PATENTS

Syllabus:

A patentee's gain on the grant of an exclusive right to "make, use and vend" a patented device constitutes ordinary income if the agreement indicates that there was no intent to presently transfer the patent.

X executed a "license" agreement under which he granted to Y Company the exclusive right to "make, use and sell" machines incorporating inventions covered by X's patents. The consideration passing to X was a "royalty" -- i.e. a percentage of the profits on future sales. The agreement further provided that it was not to be construed as a sale of the patents and that in the event X should decide to sell or otherwise dispose of his interest in the inventions or patents, Y Company was to have a 30-day option to purchase that interest. Advice has been requested as to whether the "royalty" payments should be treated as ordinary income.

A license to "make, use and vend" a patented device gives rise to a sale of the patent and to capital gains treatment if the document granting such a license is consistent, in its entirety, with a present intent by the owner to transfer the patent and if the patent qualifies as a capital asset. (Myers, 6 TC 258; Lamar v. Granger, 99 F. Supp. 17; Kronner v. U.S., 110 F. Supp. 730; U.S. v. Carruthers, 219 Fed. 2d 21; Roe v. U.S., 138 F. Supp. 567.) This rule is based on the concept that when a patentee transfers the right to make, use, and vend the patent rights exclusively to another, he has disposed of all that he acquired by virtue of the patent. Waterman v. Mackenzie, 138 U.S. 252.

A license cannot be held the equivalent of a sale of the patent, however, where the document expressly negatives any intent to presently transfer all the rights acquired by virtue of the patent. Thus, the granting of the license does not constitute the sale of a patent where no exclusive right "to make, sell and use" was granted. Kaltenbach v. United States, 66 Ct. Cls. 570, Cleveland Graphite Bronze Co., 10 TC 974, aff'd 177 Fed. 2d 200. The inclusion in the license agreement of a provision granting the licensee an option to purchase the patentee's rights at some future time is a clear indication that a present transfer was not intended and requires the conclusion that the payments received by the patentee are not capital gains but, rather, are royalty payments for the use of the taxpayer's invention and are to be treated as ordinary income. Eterpen Financiera Societed de Responsabilidad Limitada v. U.S., 108 F. Supp. 100. This holding was cited with approval in Kronner v. U.S., 100 F. Supp. 730.

Since the license agreement in the instant case contains not only an option provision but also an express statement that the transaction is not to be viewed as a sale, the Eterpen case requires the conclusion that the royalty payments be treated as ordinary income and not as capital gain.

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