



6-1-1979

Fruit and Roots: Transfers of Patents and the Shared Rights Test of Capital Gain

David K. Pansius

Follow this and additional works at: <http://scholarship.law.nd.edu/ndlr>



Part of the [Law Commons](#)

Recommended Citation

David K. Pansius, *Fruit and Roots: Transfers of Patents and the Shared Rights Test of Capital Gain*, 54 Notre Dame L. Rev. 846 (1979).
Available at: <http://scholarship.law.nd.edu/ndlr/vol54/iss5/5>

This Article is brought to you for free and open access by NDLScholarship. It has been accepted for inclusion in Notre Dame Law Review by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.

Fruit and Roots: Transfers of Patents and the Shared Rights Test of Capital Gain*

by

David K. Pansius**

I. Introduction

Now that the Revenue Act of 1978¹ has expanded the effective tax advantages of capital gain characterization, it is axiomatic that capital gains considerations will be of increasing importance in the planning and drafting of transfers of assets. Where "intangible" capital assets are involved, planning problems become particularly complex, as frequently economic considerations preclude the use of mechanisms which will necessarily yield capital gain characterization.² The taxpayer must then attempt to walk a fine, but nonetheless fuzzy and crooked, line in order to satisfy both his economic and tax objectives. Perhaps there are no greater uncertainties facing the tax planner than the attempt to distinguish a license from a sale of a patent. This article will attempt to clarify and to make more predictable this crucial tax distinction.

An analysis of capital gains characterization of patent transfers must necessarily begin with § 1235. Section 1235 provides an exception from the normal capital gains rules for certain specially qualified holders.³ A "holder" who transfers to an unrelated party⁴ "all substantial rights to a patent, or an undivided

* The author wishes to thank Professor Brookes Billman, Assistant Professor of Law, New York University, and John L. Ruppert for their kind advice which greatly aided the development of this article.

** Member of the Bar, State of Colorado. J.D. 1978, University of Denver College of Law; M.A. 1973, B.A. 1971, University of North Carolina. Associate in the firm of Law, Clark & Scheid, Denver, Colo.

1 Pub. L. No. 95-600, 92 Stat. 2763 (1978).

2 For example, when payments are periodic and based on the productivity or use of the asset transferred, the courts and the Service exhibit a tendency to characterize as ordinary income payments which, if made in a single specified lump sum, may otherwise have qualified for capital gain characterization. See note 1 *infra*; Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case*, 17 TAX L. REV. 295 (1962); Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 1003-08 (1956). Nonetheless, the practical economics of patent transfers virtually demands that payments be periodic and tied to the use of the patent. See, e.g., *Lamar v. Granger*, 99 F. Supp. 17 (W.D. Pa. 1951).

3 Section 1235(b) defines a "holder" as:

- (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) relating to such creator (within the meaning of subsection (d)).

4 Section 1235 does not apply to transfers to unrelated parties as defined in subsection 1235(d):

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 percent or more" shall be substituted for the phrase "more than 50 percent" 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.

interest therein which includes a part of all such rights" will be granted long-term capital gain treatment regardless of how long the patent was held and whether payments are to be made in the form of royalties, even in situations where the royalties are "contingent on the productivity, use, or disposition" of the patent transferred.⁵

Even if a transfer should fail to qualify under § 1235, there remains the opportunity to attain capital gain treatment through a "sale or exchange" of a § 1221 or § 1231 asset.⁶ Once the one-year holding period requirement has been satisfied, the legal standards which the transferor must meet are essentially identical to the requirements of § 1235.⁷ In order to satisfy the necessary element of sale or exchange a transferor must convey "all substantial rights" or "an undivided interest in all substantial rights of the patent," which is the same basic test contained in § 1235.⁸ In fact, when Congress enacted § 1235 it believed, with one possible exception discussed below,⁹ that it was codifying the existing law of sale or exchange as it had been applied to transfers of patents.¹⁰ Thus, the remainder of this article will for the most part ignore possible distinctions

5 I.R.C. § 1235(a).

6 Treas. Reg. § 1.1235-1(b) provides that where a transfer fails to qualify under § 1235, the tax consequences resulting from the transfer "shall be determined under other provisions of the internal revenue laws." See Rev. Rul. 69-482, 1969-2 C.B. 164; Rev. Rul. 78-328, 1978-36 I.R.B. 26.

7 Even after the passage of § 1235, the Service adhered to its position, first formalized in Mimeograph 6490, 1950-1 C.B. 9, that payments based in any respect upon the transferee's production or use of the patent precluded capital characterization, at least in those instances not governed by § 1235. Rev. Rul. 55-58, 1955-1 C.B. 7. The Service abandoned this stance in Rev. Rul. 58-353, 1958-2 C.B. 408 where it stated that when § 1235 is inapplicable the basic question becomes whether the transfer has "sufficient characteristics of a sale to qualify for capital gain treatment." By recognizing that capital gains treatment could result outside of § 1235 on transfers of patents in exchange for a royalty interest the Service acquiesced in Edward C. Myers, 6 T.C. 258 (1946); Roy J. Champayne, 26 T.C. 634 (1956); and Leonard Coplan, 28 T.C. 1189 (1957) which had judicially reached the same conclusion. The same basic rules were extended to copyrights in Rev. Rul. 60-226, 1960-1 C.B. 26.

8 "By its use of the phrase 'property consisting of all substantial rights to a patent,' we do not think Congress intended to import into section 1235 any further or different impediments to capital gain treatment than were contained in section 117 of the 1939 Code." Vincent B. Rodgers, 51 T.C. 927, 931 (1969), *acq.*, 1973-1 C.B. 2, *questioned*, Rev. Rul. 78-328. The Tax Court later overruled its holding in *Rodgers* that a transfer of patent rights limited geographically or to a restricted field of use qualifies for capital gain treatment in the case of Don Kueneman, 68 T.C. 609, 617 (1977), *app. pending*. However, the court's decision in *Kueneman* tends to imply that the only distinction between the all substantial rights test of § 1235 and the prior rules of sale or exchange was the Senate's express recognition of capital gain treatment for transfers of fragmented patents: patents limited geographically or restricted to a particular field of use. 69 T.C. at 618-19. The question of fragmented patents is discussed in greater detail at notes 28-37 *infra* and accompanying text.

Decisions which do not involve fragmentation questions routinely apply the same test of all substantial rights to both § 1235 and sale or exchange questions.

9 That exception is in the instance where the patent is fragmented into rights limited to a particular geographic territory or a limited field of use. Fragmented patents are discussed at text accompanying notes 28-40 *infra*.

10 The Senate Committee Report to § 1235, S. REP. No. 1622, 83d Cong., 2d Sess. (1954) [hereinafter cited as SENATE REPORT] states as follows:

The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the right to such periodic or contingent payments) should be transferred to the transferee for consideration. This requirement recognizes the basic criteria of a "sale or exchange" under existing law, with the exception noted relating to contingent payments, which exception is justified in the patent area for "holders" as herein defined.

Id. at 439. As was stated in note 7 *supra*, periodic payments are now recognized as permissible under the normal capital gains provisions as well.

between § 1235 and the sale or exchange rules, and focus instead on the concept of "all substantial rights" or an "undivided interest in all substantial rights."

II. The Shared Rights Test of Capital Gain

The predominant rule to date has been that in order to determine if a transferor has executed a "sale" of his patent one must first examine whether the transferor has retained rights of any value in the patent.¹¹ The argument follows that if one retains a right in a patent of substantial value, then necessarily the transferor has failed to part with all substantial rights in the patent, and thus neither § 1235 nor the sale or exchange rules have been satisfied. This analysis directed toward the value of retained rights has created conceptual and factual problems for courts analyzing patent transfers. Instinctively a court must recognize that if a transferor retains a right in the patent then that right must be of some significant value to the transferor, otherwise the transferor would not bother to contract for its retention. Yet a large number of cases have reached the contrary result, finding particular retained rights to be of insignificant value, thereby permitting capital gain characterization of the transfer.¹² What has thus developed has been a laundry list of certain specific rights which a transferor will be permitted to retain in normal circumstances. What has not developed is a uniform analysis which explains why particular rights may normally be retained, while others may not.

Such a uniform analysis emerges only when it is recognized that, contrary to customary practice, the value of a transferor's retained right is *never* a relevant consideration in analyzing the capital gain characterization of a patent transfer. The proper inquiry requires the application of the shared rights test: *Has the transferee received at least some fractional share of each and every right of the patent?*¹³ Section 1235 asks if the transferor has conveyed "all substantial rights"

11 With respect to sales or exchanges outside § 1235, a number of courts phrase the all substantial rights rule in a manner which incorrectly implies that a sale occurs if and only if the transferor retains no substantial rights in the patent; *e.g.*, "If the grantor retains no substantial rights in the subject matter of the transfer, then such transfer is a sale rather than a license." *Glen O'Brien Moveable Partition Co.*, 70 T.C. 492, 500 (1978).

Duplicate misconceptions created for § 1235 are illustrated by the court's reasoning in *Fawick v. Commissioner*, 436 F.2d 655 (6th Cir. 1971). In the hope of eliminating any doubt that a transfer of a fragmented patent would not qualify for capital gain treatment under § 1235, *Fawick* imposed a stringent two-part test: (1) The taxpayer may not retain any substantial rights in the patent. (2) The transferee must receive all substantial rights in the patent. 436 F.2d at 663. Although the latter concern that the transferee receive all substantial rights is perfectly proper, the initial requirement that the transferor retain nothing of value only distorts the all substantial rights test. *See* text accompanying notes 13-23 *infra*. The two-step test of *Fawick* was also repeated in *Mros v. Commissioner*, 439 F.2d 813 (9th Cir. 1974). *See* David R. Blake, 67 T.C. 7, 13 (1976), *app. pending*.

Unfortunately, even the legislative history sloppily emphasizes the value of the rights retained by the transferor. SENATE REPORT, *supra* note 10, at 440. As a notable contrast the Service's regulations are careful to emphasize the nature of what was conveyed to the transferee rather than what was retained by the transferor. *See* notes 30 and 59 *infra*.

12 These permissible retained rights will be discussed in the remainder of this article.

13 An imperfect judicial expression of the shared rights test can be distilled from the following language of *DuPont de Nemours & Co. v. Commissioner*, 288 F.2d 904, 912 (Ct. Cl. 1961): "When a patent owner gives not only the right to operate under the patent but in addition conveys all or a part of his remaining rights in the patent (particularly the right to exclude others from using the idea) in exchange for money, the disposition is complete."

or an "undivided interest in all substantial rights" of the patent. By its express terms the statute focuses exclusively on what was received or conveyed, not on what was retained. If the transferee has received all substantial rights in the patent, or an undivided share in all substantial rights to the patent, or a fractional share of some rights and an exclusive share of the remainder, then by the language of the "all substantial rights" rule a "sale" has been executed; the necessary rights have been conveyed regardless of what interest the transferor may or may not have retained in the patent.

Since the retained rights test ignores what the transferee receives, that test can never provide a uniform mechanism for judging patent transfers. In order to illustrate this point, apply the retained rights test to the transfer of a fractional share (or undivided interest in all substantial rights) of a patent. The retained rights test would require that the transfer be denied capital gains characterization, as the fractional share retained by the transferor is unquestionably a substantial valuable right in the patent. The uncontradicted rule, however, is that transfers of undivided interests in all substantial rights of a patent satisfy the capital gains rule of § 1235, as well as §§ 1221 and 1231.¹⁴ The retained rights test and the undivided interest rule are thus in irreconcilable conflict. As a consequence, authorities which view the value of the transferor's retained interest to be determinative of capital gain characterization are in error for failing to consider the impact of the undivided interest rule.¹⁵

A shared rights test, however, provides a consistent analysis of both the undivided interest and the all substantial rights rule. The shared rights test asks if the transferee has received or shares each and every substantial right to the patent. Where the transferee at least shares all substantial rights in the patent, the requirement that the transferee receive all substantial rights in the patent has been satisfied. In this manner the undivided interest rule merely states a particular application of the shared rights test: Even though the transferee only shares each substantial right of the patent, all substantial rights have nonetheless been received and capital gain treatment may result.

The shared rights test may be restated in terms of the transferor by posing two questions: (1) Did the transferor own at least some share in each and every right of the patent prior to the transfer? And (2) are those rights retained by the transferor also shared with the transferee? Affirmative answers yield capital gains characterization. Significantly, this test ignores the value of any retained rights. In fact, it is presumed that any right retained by the transferor will be of value, otherwise the transferor would not have bothered to retain it. However, if the right retained by the transferor is also shared with the transferee, then the transferee has nonetheless received all substantial rights or an undivided interest in all

14 In addition to the express language of § 1235 *see, e.g.*, *Parke, Davis & Co.*, 31 B.T.A. 427 (1934); *Lamar v. Granger*, 99 F. Supp. 17 (W.D. Pa. 1951); *Massey v. United States*, 226 F.2d 724 (7th Cir. 1955). In *Waterman v. MacKenzie*, a case which did not involve the tax law, the Supreme Court defined the sale of a patent to include the "undivided part or share" of "the exclusive right to make, use and vend the invention throughout the United States." 138 U.S. 252, 255 (1891).

15 Significantly, most of the cases listed in note 11 *supra* as expressing a retained rights approach to the all substantial rights rule cite with approval *Bell Intercontinental Corp. v. United States*, 381 F.2d 1004 (Ct. Cl. 1967).

substantial rights of the patent. The transferee owns outright or shares each substantial right of the patent.

III. All Substantial Rights and Assignment of Income

Assignment of income principles further illustrate the supremacy of the shared rights test. At the outset this article characterized the all substantial rights rule as a mechanism for distinguishing a sale from a license (or lease) of a patent. Although true, this statement can be misleading. To qualify for capital gains characterization a transferor must do more than "sell" "property"; the transferor must sell property of a nature which qualifies for capital gain characterization. As the Supreme Court stated in *Gillette Motor Transport, Inc.*, "[I]t is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset."¹⁶ Whereas retained rights analysis may indicate whether a transfer of property has occurred sufficient to tax the transferee rather than the transferor on the subsequent "earnings" of that property,¹⁷ retained rights analysis does not evaluate the nature of the property interest itself. As a result a retained rights test cannot determine whether the rights transferred are sufficient to amount to property which qualifies as a capital asset.¹⁸ Since the shared rights test alone evaluates what the transferee receives, it is the only test that properly addresses the "property" aspect of the capital gains characterization rules.

Viewed from this "property" perspective, the shared rights test will emerge from the application to patent transfers of the vertical/horizontal analysis of assignment of income championed by Charles Lyon and James Eustice in their article, *Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case*.¹⁹ In analyzing the Supreme Court's decision in *P. G. Lake, Inc.*,²⁰ the authors drew the distinction between the transfer of a mere right to an oil payment over a specified term and the transfer of the entire depletable interest, or a fraction of the entire depletable interest, over the entire life of the mineral interest. The former was a "horizontal slice," and advance sale of fruit. Since the fruit would generate ordinary income if sold separately, an advance sale of fruit must yield ordinary income as well. A contrary result is reached in the latter instance where a "vertical slice" has been conveyed. Where the entire or an undivided interest in the entire mineral interest has been conveyed, the fruit-bearing tree as well as the fruit has been conveyed and capital characterization will result.²¹

16 *Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130, 134 (1960). In *Gillette*, the Court held that compensation for the temporary exercise of control over business facilities by the U.S. Government did not qualify for capital gain characterization. The Court found that the Government did not take the facilities themselves but took only the right to determine the use to which those facilities were to be put.

17 See, e.g., the discussion of assignment of production payments in F. BURKE & R. BOWHAY, *INCOME TAXATION OF NATURAL RESOURCES* § 6.04-6.13 (1979).

18 "[T]he term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." 364 U.S. at 134.

19 17 TAX L. REV. 295 (1962).

20 356 U.S. 260 (1958).

21 17 TAX L. REV. at 307-09. See *id.* at 377-79.

Where intangible assets are at issue, it can become difficult to distinguish an advance sale of fruit from the transfer of a tree since the tree itself is of an indefinite character. Thus to better understand the shared rights analysis of patent transfers it is useful to extend the fruit and tree metaphor one step further and distinguish between the fruit and the roots. Each right in a patent is in essence a root of the fruit-bearing tree. The all substantial rights rule requires that for a sale of a tree to occur the transferee must obtain the right to tap into each root or right of the patent. Since fractional interests are permitted it is immaterial that the transferor's retained "tree" may also tap into roots used by the transferee. All that matters is that the transferee's interest can use each and every root of the patent, regardless of what other trees may also share some or all of those same roots.

Oversimplifying to some extent, whenever one receives at least some share of all of the rights in an asset, *i.e.*, a share of all of the roots, then it follows that one has received some form of tree. It has been argued that, as a matter of policy, the nature of the asset transferred should be determinative of whether capital gain or ordinary income treatment results.²² Since an asset satisfying the shared rights test will always represent a "tree," it follows that the transfer of a productive asset satisfying the shared rights test should also qualify for capital gain treatment.

Although discussed to some extent in the footnotes, the text of this article does not consider whether the shared rights test does or should represent the line which separates capital assets from assets embodying only ordinary income. Neither will this article address the extent to which the shared rights test may represent the line distinguishing "vertical from horizontal" cuts in the partial transfers of other assets besides patents. The analysis below is directed solely to the all substantial rights test as applied to patent transfers. For a number of reasons the fruit and roots or shared rights analysis may be suitable only for transfers of patents.²³

It is important to emphasize that the shared rights, or fruit and roots, analysis forces a court or a planner to shift his inquiry away from what was retained by the transferor to what was received by the transferee — did the transferee receive at least some interest in each and every right of the patent? In most

22 Eustice, *Contract Rights, Capital Gain, and Assignment of Income — the Ferrer Case*, 20 TAX L. REV. 1 (1964). See also Surrey, *supra* note 2.

23 One potential difference lies in the unusual benefits granted transferors of patents. In most instances, mineral interests and trademarks being but two examples, periodic payments based on the transferee's use of the asset conveyed will be treated as ordinary income, even though the "tree" may have been conveyed by the seller. In the case of patents, should a transferor meet the "sale" test, the entire consideration including the periodic payments receive capital characterization. Based on this generous result bestowed on patent transfers, it is only natural that the roots become as important as the tree. Additionally, since the patent as an intangible asset is definable only as a "bundle of rights," in a certain sense the tree becomes indistinguishable from the roots anyway. Nonetheless, one can tentatively posit the following two-part test of capital gain:

- (1) Is the underlying asset either in the nature of an investment or does it create income when put to productive use? (*P. G. Lake and Gillette Motor Transport, Inc.*) and
- (2) After the transfer, is the transferee's interest in that asset subordinate to any other interest in that asset; *i.e.*, did the transferee receive at least some share in each and every right of the asset?

Certainly these broad rules must defer to special considerations relating to the nature of the specific property involved.

instances to apply this test one need only examine whether every right retained by the transferor is also shared with the transferee. In this manner, if the transferor owned all substantial rights prior to the transfer, then the transferee's tree will have access to each and every root and the sale of a capital asset will result. However, if the transferor did not own or share all substantial rights prior to the transfer, then no capital characterization can result regardless of what the transferor did or did not retain. The shared rights test must always be applied together with the requirement that the transferee receive at least some part of each and every right to the patent.

IV. Legislative History and Shared Rights

Before applying the shared rights test to actual court decisions, it is useful to examine whether "shared rights" also explains the legislative history behind the enactment of § 1235 and the codification of the all substantial rights test. The Internal Revenue Service takes the position that the language in § 1235 which grants capital gain treatment to transfers of an undivided interest in all substantial rights of a patent refers only to transfers of the *identical* fractional interest in each and every right of the patent.²⁴ This reasoning would preclude the shared rights test, as that test assumes that in a qualifying transfer the transferee may often receive *differing* "fractional" interests in each substantial right; indeed, the transferee must receive exclusive interests in all rights with the exception of those retained rights which the transferor and the transferee share.

Significantly, no explicit support for the Service's apparent position can be found in the legislative history: The definition of "undivided interest" contained in the Senate Report is as follows:

By "undivided interest" a part of each property right represented by the patent (constituting a fractional share of the whole patent) is meant (and not, for example, a *lesser* interest such as a right to income, or a license limited geographically, or a license which conveys some, but not all, of the claims or uses covered by the patent).²⁵

The Senate's reference to "a part of each property right" as meaning "a fractional share of the whole patent" might well be taken as evidence that the Senate intended to require that a transfer of an undivided interest constitute a transfer of the identical fractional interest in each right of the patent. However, the language of the Report did not refer to "the *identical* fractional share of the whole patent," nor did the language refer to "the *identical* part of each property right represented by the patent." If anything, the Senate's definition of "undivided interest" would indicate that Congress did not expressly consider the shared rights test posited above. Rather, Congress only meant to insure that transfers of frag-

²⁴ Treas. Reg. § 1.1235-2(c) states in part: "A person owns an 'undivided interest' in all substantial rights to a patent when he owns the same fractional share of each and every substantial right to the patent." See Rev. Rul. 59-175, 1959-1 C.B. 213, 214-15.

²⁵ SENATE REPORT, *supra* note 10, at 439 (emphasis added).

mented patents, *i.e.*, patents limited geographically or restricted in field of use, be denied capital gain treatment.²⁶

Moreover, the Service's view of undivided interest contradicts the Senate's apparent intent to grant certain minimum interests potential capital gain characterization. Under the Service's rule "all substantial rights" have not been transferred in those instances where, instead of owning the identical fractional interest in each and every right of the patent, the transferee owns an exclusive interest in some of the rights. No capital gain characterization will result under the undivided interest rule since the transferee's exclusive rights result in differing fractional interests in the rights which the transferee received. If, however, the transferor denied the transferee his exclusive rights and transferred only a fractional share identical to the fractional share of the remaining rights, capital gain characterization is now permitted according to the undivided interest rule. Thus, under the Service's test, by transferring a lesser interest, the transferor may convert ordinary income into capital gain.

Congress could never have intended such a contradictory result. The language of the Senate Report quoted above expresses a concern over transfers of interests in patents which are *lesser* interests than transfers of an undivided part of a patent.²⁷ Since any interest which satisfies the shared rights test must also constitute an interest which is *greater than or equivalent to* the explicitly endorsed undivided interest in all substantial rights to the patent, the Senate Report cannot be interpreted to preclude the shared rights test. In fact, the Senate's reference to lesser interests would imply that any interest which satisfies the shared rights test necessarily satisfies the all substantial rights rule. If a transfer of an undivided interest in a patent is a transfer of all substantial rights, then so must the transfer of the equivalent or greater interest, the interest which satisfies the shared rights test, also qualify as a transfer of all substantial rights.

Coincidentally, the converse of the shared rights test — there is no transfer of an undivided interest unless all substantial rights in the patent are at least shared — when rigidly applied, eliminates the need to expressly deny capital gain characterization to transfers of fragmented patents in exchange for payments contingent on use. As noted above, the Senate expressly excluded from § 1235 transfers of such lesser interests as "a right to income, or a license limited geographically, or a license which conveys some, but not all, of the claims or uses covered by the patent." These forbidden examples each represent instances where the transferor has failed to satisfy the shared rights test: Where a transferor parts with only an income interest, at minimum he retains the unlimited right to create further sublicenses; this right is not shared with the transferee and thus there can be no "sale" under the all substantial rights rule. Similarly, where the transferred patent is limited geographically, the transferor retains the exclusive right, not shared with his transferee, to use the patent in the remaining geographic terri-

²⁶ In *Estate of Klein*, 507 F.2d 617 (7th Cir. 1974), *cert. denied*, 421 U.S. 991 (1975), *rev'g*, 61 T.C. 332, the court intimated that the purpose behind the Senate's reference to "a part of each property right" and "a fractional share of the whole patent" was limited to distinguishing undivided interests from fragmented patents. 507 F.2d at 621.

²⁷ *Lamar v. Granger*, 99 F. Supp. 17, 38 (W.D. Pa. 1951) also spoke of an interest *less* than an undivided share as being a mere license.

tory. Finally, where the transferor parts with only some of the claims or uses of the patent the remaining claims or uses are held exclusively by the transferor and not shared with the transferee; the shared rights test has not been satisfied.

Despite the language of the Senate Report, only recently in the *Kuenemann*²⁸ decision did the Tax Court take the position that a transfer of a fragmented patent could not qualify for capital gain treatment under § 1235. The reasoning had been that if all substantial rights to the fragment had been conveyed then the all substantial rights test had been satisfied,²⁹ and that the Service's regulations to the contrary were in error.³⁰ To a great extent this conclusion had been based on the decision of *Waterman v. McKenzie*, which in defining what constituted a sale of a patent expressly endorsed transfers limited geographically.³¹ The *Waterman* case did not involve the tax law, however, and thus has no real precedence with respect to the subsequently created and legislated "all substantial rights" rule. *Kuenemann* recognized this distinction³² and brought the Tax Court in line with the prior holdings of the courts of appeal which had consistently held that fragmented transfers could not qualify for capital gain characterization under § 1235.³³

Since the rationale for the current ban on fragmentation rests in the legislative history of § 1235, it can be argued that "all substantial rights" has a different, more permissive meaning when used to judge the sale or exchange of a § 1221 or § 1231 asset.³⁴ The reasoning would be as follows: Since § 1235 also preserved a transferor's ability to resort to normal capital gain rules and since fragmentation had been permissible under normal capital gain rules prior to § 1235,³⁵ then so should fragmentation still be permitted outside the scope of § 1235.³⁶ The result of this theory would be that with respect to fragmentation issues "all substantial

28 Don Kueneman, 68 T.C. 609 (1977).

29 Vincent B. Rodgers, 51 T.C. 927 (1969), *acq.*, 1973-1 C.B. 2, *questioned*, Rev. Rul. 78-328. See Estate of Klein, 61 T.C. 332 (1973), *rev'd*, 507 F.2d 617 (7th Cir. 1974); Thomas L. Fawick, 52 T.C. 104 (1969), *rev'd*, 436 F.2d 655 (6th Cir. 1971); William S. Rouverol, 42 T.C. 186 (1964), *nonacq.*, 1965-2 C.B. 7.

30 Treas. Reg. § 1.1235-2(b)(1) states in part:

The term "all substantial rights to a patent" does not include a grant of rights to a patent —

(i) Which is limited geographically within the country of issuance;

(iii) Which grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; or

(iv) Which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant.

31 138 U.S. at 255.

32 68 T.C. at 617-18.

33 Estate of Klein, 507 F.2d 617 (7th Cir. 1974), *cert. denied*, 421 U.S. 991 (1975), *rev'g*, 61 T.C. 332; *Mros v. Commissioner*, 493 F.2d 813 (9th Cir. 1974), *rev'g*, T.C. Memo 1971-123; *Fawick v. Commissioner*, 436 F.2d 655 (6th Cir. 1971), *rev'g*, 52 T.C. 104.

34 Cohen & Suttle, *Transferring Patents and Know-How*, 8 TAX ADVISOR 346, 350 (1977).

35 See, e.g., *Merck & Co. v. Smith*, 261 F.2d 162 (3rd Cir. 1958); *United States v. Caruthers*, 219 F.2d 21 (9th Cir. 1955); *First Nat'l Bank of Princeton v. United States*, 136 F. Supp. 818 (D.N.J. 1955); *Estate of Milton P. Laurent*, 34 T.C. 385 (1960), *nonacq.*, 1961-2 C.B. 6; *Vincent A. Marco*, 25 T.C. 544 (1955), *acq.*, 1958-2 C.B. 6.

36 See also *Allied Chem. Corp. v. United States*, 66-1 U.S.T.C. ¶ 9212 (S.D.N.Y. 1966), *aff'd*, 370 F.2d 697 (2d Cir. 1967); Rev. Rul. 60-226, 1960-1 C.B. 26. See generally *Bell International Corp. v. United States*, 381 F.2d 1004, 1014 (Ct. Cl. 1967). But see also *Redler Conveyor Co. v. Commissioner*, 303 F.2d 567 (1st Cir. 1962) (transfers of patents limited in field of use were licenses and not sales, thereby creating personal holding company income).

rights" would have two different meanings.

However, by reading the word "all" to truly mean *all* substantial rights, the shared rights test precludes such an unjustified "double standard." As pointed out above, whenever a patent is fragmented all substantial rights are not conveyed; the retained rights of the transferor are not shared with the transferee. Since the transferor has kept some of the roots for his exclusive use, capital characterization must be denied. Considering that § 1235 was designed to provide special relief for qualified holders, a broader test of sale or exchange under §§ 1222 and 1231 would generate an incongruous result, and would indeed substantially frustrate the intent of Congress.³⁷

The shared rights test, however, does not preclude capital gain characterization of patent fragments in all circumstances. A patent limited geographically or to a particular field of use nonetheless represents property capable of supporting capital gain characterization.³⁸ If a transferor were to convey at least some share of all substantial rights in the fragment in exchange for a fixed sum rather than payments contingent on use, possibly the legislative prohibition created coincident

37 Congress enacted § 1235 to satisfy two purposes: first, to insure that certain transfers of patents in exchange for payments contingent on use would be granted capital gain treatment despite the contrary position taken by the Service; and second, to insure that capital gains benefits were easily available to the ordinary inventor so as to provide a special incentive to the inventor. SENATE REPORT, *supra* note 10, at 439. See, e.g., *Fawick v. Commissioner*, 436 F.2d 655, 661 (6th Cir. 1971).

Although a portion of the special incentive of § 1235 was relief from having to satisfy the holding period requirement, it would seem nonetheless contradictory to impose on the inventor a restricted test of sale or exchange which need not be satisfied once outside the confines of § 1235. See *David R. Blake*, 67 T.C. 7, 17 (1976), *app. pending*, which stated: "We see no reason why section 1235 should be more strictly applied [than §§ 1221 and 1222]." Stated in the converse, there is no reason why §§ 1221 and 1222 should contain a test of sale or exchange more permissive than the legislative rule expressed in § 1235.

The argument for symmetry between §§ 1221 and 1235 gains additional credence when examined in terms of Rev. Rul. 69-482, 1969-2 C.B. 164. In that ruling the Service stated that § 1235 was not the exclusive capital gains rule for "holders" of patents.

By applying Rev. Rul. 69-482 to the specific problem of fragmented patents a permissive definition of "all substantial rights" under § 1221 would create a loophole whereby inventors (aside from possibly professional inventors) could obtain capital gain characterization of fragmented patent transfers merely by holding the property long enough to satisfy the one-year holding period requirement. Without symmetry in the application of the "all substantial rights" rule the practical impact of the legislative prohibition regarding transfers of patent fragments has been substantially frustrated.

Of course the same reasoning applies with respect to the express statutory prohibition regarding transfers to related parties. Significantly, although later courts have distinguished *Poole*, its reasoning requiring the exclusivity of § 1235 as applied to "holders" has yet to be expressly rejected, leaving open the possibility that the service was too generous in promulgating Rev. Rul. 69-482. See, e.g., *Newton Insert Co.*, 61 T.C. 570 (1974), *aff'd per curiam*, 545 F.2d 1259 (9th Cir. 1976) (although *Poole* may deny capital gain characterization to a transfer described in § 1235 which does not satisfy § 1235, normal rules apply with respect to whether a sale has occurred for purposes of applying § 1245). *Ray E. Omholt*, 60 T.C. 541, 547 n.7 (1973), *acq.* (neither party argued that § 1235 exclusively governed the transaction in question). *Lan Jen Chu*, 58 T.C. 598, 608 n.1 (1972) (argument that § 1235 operated to preclude capital gains characterization not raised by the Service); *Thomson v. United States*, 25 A.F.T.R. 2d 70-697 (E.D.N.Y. 1969) (*Poole* does not necessarily deny capital gains treatment to transfers by "nonholders" in exchange for payments contingent on use). See also *David R. Blake*, 67 T.C. 7, 12 n.4 (1976) (taxpayer did not raise the alternative theory that capital gain characterization was warranted under other sections beside § 1235). Indeed, at least one court has followed *Poole*, rejecting the view that a holder who transfers a patent to a related person in exchange for contingent payments may nonetheless seek capital gain characterization outside the confines of § 1235. *William W. Taylor*, 1970 T.C.M. ¶ 70,325, at 1633 n.7.

38 See cases cited at note 35 *supra*.

with the enactment of § 1235 will be avoided.³⁹ The transfer will satisfy the shared rights test since the transferee received at least some share of each substantial right in a contract (as distinguished from a patent) which itself qualifies as capital property.⁴⁰

Before addressing further applications of the shared rights test one additional comment must be made about the legislative history of § 1235. The Senate Report expressly permits a transferor to "retain" in the patent conditions subsequent or similar devices in the nature of security interests, including title to the patent.⁴¹ In other words the transferor may assert against the patent a lien for nonpayment of royalties or similar breach by the transferee. Such security devices are outside the application of the all substantial rights rule as they do not truly involve the beneficial rights of the patent.⁴²

V. The Shared Rights Test and Retained Benefits

To summarize once more, capital gain characterization of an asset transfer should turn, not on factual questions of value, but rather on the legal character of the asset conveyed. Only the shared rights test limits the all substantial rights rule to an exclusively legal inquiry: The shared rights test assumes that a retained interest is valuable, otherwise it would not appear in the contract. If the parties treat an interest as substantial by placing it in their contract, the courts should be relieved of having to reevaluate that interest for purposes of the tax laws. The true issue is not value, but whether the retained right is shared with the transferee so that the transferee can be said to have received at least a part of all substantial rights in the patent, thereby meeting the requirement of a sale. The analysis

39 Section 1235 was enacted to provide special rules where, in part, the payment received was in the nature of royalties. See, e.g., *Thomson v. United States*, 25 A.F.T.R. 2d 697 (E.D.N.Y. 1969); note 37 *supra*. Where payments are for fixed consideration a transaction of the nature described in § 1235 has not occurred. Thus, the legislative ban to fragmented transfers by holders under § 1235, and as extended by implication to transfers by nonholders under § 1221, should be inapplicable. Rather, capital gain characterization should be assessed under the rules applicable to the sale of contract rights. See notes 51, 52, and 65 *infra*.

40 See the two-part test of capital gain posited in note 23 *supra*.

41 "[R]etention by the transferor of rights in the property which are not of the nature of rights evidenced by the patent and which are not inconsistent with the passage of ownership, such as a security interest (e.g., a vendor's lien) or a reservation in the nature of a condition subsequent (e.g., a forfeiture on account of nonperformance) are not to be considered as such a retention as will defeat the applicability of this section." SENATE REPORT, *supra* note 10, at 440. See *Treas. Reg.* § 1235-2(b)(2).

42 A security device will return the patent to the transferor only upon the buyer's default. Since the event of default is beyond the control of the transferor, no right in the patent has been retained by the transferor. This distinction based on right to control is approved by the Service in *Rev. Rul.* 75-202, 1975-1 C.B. 170 regarding whether a sale of a copyright has occurred. See also, *Merck & Co. v. Smith*, 261 F.2d 162 (3rd Cir. 1958); *Watson v. United States*, 222 F.2d 689 (10th Cir. 1955); *Edward C. Myers*, 6 T.C. 258, 264 (1946), *acq.*, 1958-2 C.B. 6.

However, should a transfer of patent rights be terminable at the election of the transferor at any time prior to the expiration of the patent, then from the seller's standpoint the patent is no longer just collateral to insure performance on the contract; the transferor has now retained a reversionary interest in the patent. This retained reversion necessarily violates the shared rights test, and capital characterization must be denied the transfer. *Young v. Commissioner*, 269 F.2d 89 (2d Cir. 1969); *Jacques R. Milberg*, 52 T.C. 315 (1969); *Franz Martini*, 38 T.C. 168 (1962); *Andrew Szegari*, 1975 T.C.M. ¶ 75,284 (1975). An analogous rule exists with respect to trade secrets where the transfer must be at least for the duration of the useful life of the technology transferred. *Pickren v. United States*, 378 F.2d 595 (5th Cir. 1967); *Taylor-Winfield Corp.*, 57 T.C. 205 (1971), *aff'd per curiam*, 30 A.F.T.R. 2d 5711 (6th Cir. 1972); *Julian A. McDermott*, 41 T.C. 50 (1963).

below illustrates how the shared rights test, because it is a legal rather than a factual test, creates order and consistency in areas which heretofore have been characterized only by confusion.

The application of the shared rights rule is most easily visualized in instances where the transferor has retained a benefit of the patent itself. Consider, for example, a transfer of a patent where the taxpayer omits to transfer the right to use, or expressly reserves the right to use, the patented product. The almost universal position of the courts has been that this retained right in the patent is not substantial enough to defeat capital gain characterization.⁴³ The Senate Report itself expressly pointed to the retained right to use as a prominent example of a retained interest which is ordinarily not substantial.⁴⁴

A proper analysis, however, reaches this conclusion by applying the shared rights test. A retained right to use will not defeat a sale of a patent because the transfer of the rights to manufacture and sell necessarily implies that the right to use has been transferred as well.⁴⁵ In other words the right to use is now shared between the transferor and transferee; the transferor's retained right in no way detracts from the transferee's full use and enjoyment of the patent and a sale thus results.⁴⁶ If, however, the transferor had expressly denied certain use rights to the recipient of the patent, no sale should result as rights are no longer shared.⁴⁷ The de minimus value rule will never address this distinction, although, as a practical matter, with respect to this particular right the distinction may never become important.

A far more difficult problem is presented when the transferor has retained the right to use the patent itself, as well as the patented article, *i.e.*, a nonexclusive license. Although not an application of the all substantial rights rule, *United States v. Dresser*⁴⁸ in substance examined that very issue. In *Dresser* the original patent owner transferred to the taxpayer an exclusive license to patent rights relating to a method and apparatus for logging oil wells, reserving to itself a nonexclusive license. Some time later the taxpayer transferred back to the original owner the exclusivity feature of its license in exchange for the fixed sum of \$500,000 payable out of 25% of gross receipts. The net result was that the taxpayer now owned a nonexclusive license and the original owner now owned the exclusive license.⁴⁹

Under the retained rights test of the all substantial rights rule, no sale of a

43 See, *e.g.*, *Lockhart v. Commissioner*, 258 F.2d 343 (3rd Cir. 1958); *Rollman v. Commissioner*, 244 F.2d 634 (4th Cir. 1957); *C. A. Norgren Co. v. United States*, 268 F. Supp. 816 (D. Colo. 1967); *Flanders v. United States*, 172 F. Supp. 935 (N.D. Cal. 1959); *Gruber v. United States*, 158 F. Supp. 510 (D. Ore. 1957); *A. E. Hickman*, 29 T.C. 864 (1958); *Arthur C. Ruge*, 26 T.C. 138 (1956), *acq.*, 1958-2 C.B. 6; *William W. Taylor*, 1970 T.C.M. ¶ 70,325 (1970).

44 "[T]he courts have recognized that an exclusive license agreement in some instances may constitute a sale for tax purposes even where that right to 'use' the invention has not been conveyed to the licensee." See *Treas. Reg. § 1.1235-2(b)(3)(ii)*.

45 See *C. A. Norgren Co. v. United States*, 268 F. Supp. 816, 821 (D. Colo. 1967); *Flanders v. United States*, 172 F. Supp. 935, 950 (N.D. Cal. 1959).

46 *Rollman v. Commissioner*, 244 F.2d 634, 639 (4th Cir. 1952).

47 The regulations and the legislative history would seemingly permit exceptions. See note 44 *supra*.

48 324 F.2d 56 (5th Cir. 1963).

49 9 A.F.T.R. 2d 1597 (N.D. Tex. 1962).

capital asset would result, as clearly the nonexclusive license retained by the taxpayer represented substantial rights in the patent or the asset. The court, however, only analyzed whether the transfer of the exclusivity feature alone was the sale of a capital asset. The court determined that it was⁵⁰ distinguishable from an earlier case which had apparently held to the contrary.⁵¹

The identical result is reached by applying the shared rights test *as if* an entire interest in a patent had been conveyed. Admittedly the exclusivity feature itself did not embody a share of all rights in the patent. However, because the transferee already owned a nonexclusive license, at the close of the transfer it owned all rights in the patent, subject only to outstanding nonexclusive licenses; *i.e.*, the transferee owned at least some share of all substantial rights in the patent. Viewed in this perspective it is but a short step to say that when a nonexclusive license is reserved at the time an entire patent is transferred, at least some share of all substantial rights has been conveyed and therefore a sale must result.⁵²

Although distinguishable if for no other reason than payment was in the form of a fixed sum,⁵³ *Dresser* is nonetheless instructive as its consideration of the exclusivity feature alone tends to highlight a question which has plagued courts attempting to apply the retained rights test of value to partial transfers of patent interests: In order to transfer "all substantial rights of the patent" must a transferor convey all substantial rights of the patent then existing, or need the transferor convey only all those rights which he owns at the time of the transfer? Under the shared rights test the answer is of course neither. The true inquiry is: "Did the transferor convey some part of each and every substantial right of the patent?" An affirmative response creates a sale of a patent, regardless of what the transferor owned at the time of the transfer, regardless of what the transferor

50 324 F.2d at 58-61.

51 In *Wiseman v. Halliburton Oil Well Cementing Co.*, 301 F.2d 654 (10th Cir. 1962) the court characterized as ordinary income payments received in exchange for the exclusivity feature of a patent. The court stated that the royalty payments received by the seller represented but a substitute for the ordinary income which the seller would have received had he himself assigned nonexclusive licenses in the patent. The court cited, *inter alia*, *P. G. Lake* and *Gillette Motor Transport, Inc.*

Dresser distinguished *Halliburton* on the basis that the transferor in *Dresser* could not execute any sublicenses; therefore, payments received in exchange for the exclusivity right could not be construed as a substitute for ordinary income which the transferor otherwise would have earned. 324 F.2d at 59. However, in *Halliburton* the transferor similarly could not execute any sublicenses without the consent of the owner of the nonexclusive license. Consequently, this basis for distinguishing the two cases appears to be weak.

The true distinguishing feature between *Dresser* and *Halliburton* is the nature of the payment. The transferor in *Dresser* was entitled only to a fixed sum, albeit payable out of gross receipts. *Halliburton* however received the right to one-third of all future royalties which its transferee received on subsequent sublicenses that it was to execute. This apparent distinction between *Halliburton* and *Dresser* conforms to the hypothetical alternatives to § 1235 posed at text accompanying notes 38-40 *supra* and 65 *infra*.

52 Alternatively, apply the two-part test of capital gain posited in note 19 *supra*. The underlying productive asset at issue is a patent, clearly a capital asset within the limits described in *Gillette Motor Transport, Inc.* What the transferee received through the exchange of the exclusivity feature was that crucial right in the patent which transformed his nonexclusive license into an exclusive license. In other words, the exclusivity feature was that crucial right which transformed a noncapital asset (at least with respect to the patent rules) into a capital asset. See the discussion of nonexclusive licenses at text accompanying notes 54-92 *infra*. Since the exclusivity feature was the critical right necessary for capital gain characterization of the underlying property, then so must the exclusivity feature itself be property worthy of capital gain characterization.

53 See note 51 *supra*.

sold prior to the transfer, and, most importantly, regardless of what the transferor may have retained for himself at the time of transfer. The courts have had extreme difficulty with these issues because they have yet to ask the proper question. Once the proper test is applied, the proper result is readily reached.

In *First National Trust and Savings Bank of San Diego v. United States*,⁵⁴ the court considered whether a transferor had conveyed all substantial rights to the patent where the rights transferred were subject to a nonexclusive license previously granted by the transferor. The court ruled that to qualify as a sale of a capital asset the transferor must convey all of the rights outstanding in the patent, not just the rights owned by the transferor at the time of the transfer: "'Rights to a patent' means the traditional rights given the inventor by a patent; 'all substantial rights' means all of those original rights which are of value at the time the rights to a patent (or an undivided interest therein) are conveyed."⁵⁵

Although *San Diego* has been much criticized,⁵⁶ and although the result is clearly incorrect,⁵⁷ one must credit the *San Diego* court with at least adopting the proper approach to the retained interest, if not the proper analysis. Admittedly, *San Diego* paid obligatory obeisance to the retained rights test and noted that the royalties which the transferor was continuing to receive under the outstanding nonexclusive license represented the retention of a substantial right in the patent.⁵⁸ However, the true concern of *San Diego* was not with what was retained but rather with whether all substantial rights were *received* by the transferee. The court defined all substantial rights in terms of the "traditional rights" of a patent, not what rights the transferor happened to own at the time of transfer or even at some earlier time.⁵⁹ All that *San Diego* failed to recognize was that the outstanding nonexclusive license was merely a bundle of "shared" rights; the transferee in fact received some part of each and every substantial right of the patent and therefore a sale should have resulted.

The decisions postdating *San Diego* generally reach the correct result, but do so by employing improper reasoning thereby furthering continued litigation. In *Donald C. MacDonald*⁶⁰ the court considered whether the transfer of a patent subject to an outstanding royalty-free nonexclusive license was a sale for purposes of §§ 1221 and 1231. The court properly found that a sale had occurred, rejecting the reasoning of *First National Trust and Savings Bank of San Diego v. United States*.⁶¹ *MacDonald* framed the test purely from the standpoint of what the

54 200 F. Supp. 274 (S.D. Cal. 1961).

55 *Id.* at 281.

56 *See, e.g., Bell Intercontinental Corp. v. United States*, 381 F.2d 1004 (Ct. Cl. 1967); *Donald C. MacDonald*, 55 T.C. 840 (1971).

57 *See* text accompanying notes 79-89 *infra*.

58 200 F. Supp. at 282.

59 200 F. Supp. at 281. *See* the discussion of *San Diego* in *Donald C. MacDonald*, 55 T.C. 840, 859 (1971), *acq.*, 1973-1 C.B. 1.

The Service's position expressed in its regulations adopts the thrust of *San Diego* as analyzed in this article: "The term 'all substantial rights to a patent' means all rights (*whether or not then held by the grantor*) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred." Treas. Reg. § 1.1235-2(b)(1) (*emphasis added*). *Bell Intercontinental Corp. v. United States*, 381 F.2d 1004, 1015 n.5 (Ct. Cl. 1967) took the view that *San Diego* and the Regulations were inconsistent; significantly, *Bell's* quotation of the Regulations omits the parenthetical phrase emphasized above.

60 55 T.C. 840 (1971), *acq.*, 1973-1 C.B. 1.

61 *Id.* at 859.

transferor retained rather than what the transferee received: "The issue of whether all substantial rights have been transferred (that is, whether there has been a sale) should arise only when the transferor has retained rights of some sort."⁶² Based on this rule it did not matter if less than 100% of the original patent rights were transferred, rather a sale results when "all remaining rights in a patent are transferred."⁶³ Since the taxpayer retained nothing, a sale must have been executed.

A strict application of the *MacDonald* test yields strange results. What if MacDonald had owned only a nonexclusive license instead of the exclusive license considered by the court? If MacDonald assigned all his rights in his nonexclusive license, under the court's reasoning he would still be entitled to capital gain treatment since he retained no rights in the patent; the nonexclusive license was all he owned. Such a conclusion makes a mockery of the all substantial rights test and indeed cannot be supported under existing law. If the sale of a nonexclusive license is to qualify for capital gain treatment, it must do so under the rules applicable to sales of contract rights, not sales of patents and the all substantial rights test.⁶⁴ For example, the transfer of a nonexclusive license in exchange for a fixed sum may qualify for capital gain characterization under circumstances where the seller is not a "dealer" in patent licenses.⁶⁵

In *Transducer Patents Co. v. Renegotiation Board*,⁶⁶ the court also considered whether the transfer of a patent subject to a preexisting nonexclusive royalty-free license could qualify for capital gains characterization under the all substantial rights rule. To its credit, the court did note that prior to the carve-out of the nonexclusive license the transferor owned all the rights in the patent.⁶⁷ Since a nonexclusive license only permits its owner to share in some rights of the patent, it necessarily follows that, after the nonexclusive license was granted, the taxpayer still retained at least some share of each and every right of the patent. Consequently, when this remaining interest was conveyed, an interest satisfying the shared rights test was received by the transferee, and thus capital gain characterization may result to the transferor.

Unfortunately, instead of resting its conclusion on shared rights analysis, *Transducer* lapsed into applying the retained rights test: The transfer qualified

62 *Id.*

63 *Id.*

64 *See* Eustice, *supra* note 22.

65 By executing a transfer in exchange for a fixed sum rather than contingent payments, the restrictive rules of § 1235, as also extended to § 1221, may be avoided. The fixed consideration potentially relieves the taxpayer from the burden of demonstrating that a share of all substantial rights in a patent has been conveyed. Since contingent payments are not being claimed, the property need no longer rise to the level of a patent, permitting the nonexclusive license to be tested under the rules applicable to contract rights. *See* note 39 *supra*. It would seem that a nonexclusive patent license could satisfy the "property" requirement of *Gillette Motor Transport Inc.* Consequently, as long as the license was held for the required period, and as long as a share of all substantial rights in the nonexclusive license was conveyed, and as long as the seller is not a "dealer" in nonexclusive licenses so as to invoke the exception of § 1221(1), capital gain characterization appears warranted.

If indeed the above hypothesis proves correct, capital gain characterization should result irrespective of whether the nonexclusive license was sold before or after the remaining rights in the patent were sold.

66 58 T.C. 329 (1972), *aff'd*, 492 F.2d 247 (9th Cir. 1973).

67 *Id.* at 344.

as a sale because the outstanding license was royalty-free. Since the license was royalty-free the transferor retained nothing of value and thus capital gain treatment is justified. The court then compounded its error by commenting that it was not considering whether a sale would result if the taxpayer had retained a right to receive royalties under a preexisting nonexclusive license of the patent (the facts of *San Diego*).⁶⁸

In Revenue Ruling 78-328⁶⁹ the Service also addressed the nonexclusive license question. In an attempt to limit the *MacDonald* holding, the Service sought to explain its earlier acquiescence in *MacDonald*⁷⁰ as an acquiescence in result only, not an indication of agreement with the reasoning of *MacDonald*. What the Service found to be determinative of the sale issue was the fact that the nonexclusive, royalty-free license was carved from the patent *before* the transferor received his rights. Thus, in the example discussed in the Ruling the Service states that a sale has occurred "because Z transferred all the rights it had ever held in the property."⁷¹

These distinctions drawn by *Transducer* and the Service are as misleading as the reasoning of *MacDonald* itself. All substantial rights of the patent must be transferred, *i.e.*, received, if a sale of a capital asset is to occur.⁷² It is immaterial to the transferee whether the outstanding nonexclusive license pays royalties to the transferor or is royalty-free; the transferee's rights are identical in either case. Neither is it relevant whether the nonexclusive license was created by the transferor-taxpayer or by some earlier transferor from whom the taxpayer received his interest. Once again, in either instance the rights received by the transferee are identical.

A retained rights test is nonetheless forced to grapple with such irrelevant distinctions. The shared rights test does not. A receipt of an exclusive license subject to a nonexclusive license is a receipt of at least some part of all substantial rights in the patent. Stated in the alternative, all outstanding rights to the patent not owned exclusively by the transferee are at least shared with the transferee. Since the shared rights test looks exclusively to what the transferee receives, a sale results regardless of who created the outstanding license or whether the outstanding license pays a royalty.

Transducer relied heavily on the Court of Claims decision in *Bell Intercontinental Corp. v. United States*.⁷³ Indeed that case is probably the leading opinion addressing the issue of transfers subject to nonexclusive licenses. Bell, the transferor-taxpayer, was a member of an industry cross-licensing agreement which required Bell and all other members to transfer nonexclusive licenses for certain kinds of patents to the association for use by all members of the association. Under the terms of the agreement with the association, the association paid Bell a royalty on the nonexclusive license which it received. When Bell sought to later sell its

68 *Id.*

69 1978-36 I.R.B. 26.

70 1973-1 C.B. 1.

71 1978-36 I.R.B. 26.

72 The test of sale or exchange requires that "all substantial rights evidenced by the patent . . . should be transferred to the transferee for consideration." SENATE REPORT, *supra* note 10, at 439 (emphasis added).

73 381 F.2d 1004 (Ct. Cl. 1967).

patent rights, it made the transfer subject to the existing nonexclusive license to the association as required by its agreement with the association. Bell also reserved the right to receive any additional royalties which the association might grant on its nonexclusive license. The Service challenged capital gain treatment of the transfer based in part on the outstanding nonexclusive license and Bell's reservation of the right to receive any future royalty payments.⁷⁴

Bell correctly found that a sale of a capital asset had occurred. *Bell* distinguished the "100 percent of all rights in the patent" rule expressed in *San Diego* by relying in part on the undivided interest reasoning upon which the shared rights test is based: "The first basis for the [*San Diego*] holding — that a sale requires transfer of all substantial rights in the patent *when issued* — would appear inconsistent with what would seem an established principle that for capital gain purposes, a taxpayer may sell a partial interest in an invention."⁷⁵ The second argument of *San Diego*, that the right to receive royalties is in itself a substantial interest in the patents, was also rejected by *Bell*. The right to royalties was not a "substantial *property* right in a patent," and therefore did not violate the all substantial rights test.⁷⁶

The most significant aspect of *Bell*, however, is that the court to some degree attempts to conceptualize the basic character of the transaction which occurred, rather than relying exclusively on a mechanical application of the retained rights rule. The court characterized the *Bell* transfer as follows:

By analogy, the [patent transfer] would thus seem no different in principle than one in which a grantor conveys a fee simple interest in (and, subject to) an irrevocable easement in perpetuity [which] the grantor had previously conveyed to a third party. The fact that the grantor in such circumstances reserved the right to obtain future payments from the easement holder does not mean that the grantor retained a continuing property interest in the realty — indeed, in the present illustration he divested himself entirely of that; it means rather than the grantor retained a contractual right vis-a-vis the easement holder to receive payments for an interest already conveyed.⁷⁷

To the extent that *Bell* notes that a fee simple interest in property has been conveyed even though that property is subject to an outstanding easement, *Bell* applies the shared rights test. When a transferee receives property subject to an easement, as with the receipt of a patent subject to a nonexclusive license, the right to put the property to productive use is in some degree shared rather than owned outright. Nonetheless, because these rights are at least shared, all substantial rights have been transferred, and a sale of property results.⁷⁸

⁷⁴ *Id.* at 1011-13.

⁷⁵ *Id.* at 1014. Unfortunately, *Bell* cited as an example of partial transfers, conveyances of fragmented patents, interests which no longer receive capital gain treatment at least under § 1235. See text accompanying notes 28-37 *supra*.

⁷⁶ *Id.* at 1015. See *Van Dale Corp.*, 59 T.C. 390, 399 (1972).

⁷⁷ *Id.* at 1013. This passage was quoted with apparent approval in *Transducer Patents Co. v. Renegotiation Board*, 58 T.C. 329, 344 (1973), *aff'd*, 492 F.2d 247 (9th Cir. 1973).

⁷⁸ See also *Van Dale Corp.*, 59 T.C. 390, 399 (1972) which cites *Bell* as holding that the outstanding license "did not in any way limit the purchaser's use of the patent and that it did not constitute the retention of a substantial right in the patent by the seller." The key finding for the purpose of the shared rights test is that the outstanding interest did not interfere with the transferee's "use of the patent."

Applying the same analysis, it should be evident that the shared rights test would also recognize a sale even in those instances where the transferor has created and reserved a nonexclusive license at the time he transferred the patents. It is now accepted that a transfer of all rights in a patent with the simultaneous grantback to the transferor of a nonexclusive license qualifies as a sale.⁷⁹ Practically, and conceptually, a grantback is no different from a transaction in which the transferor himself reserves the nonexclusive license at the point of initial transfer. Because the transfers are in reality identical, the identical conclusion of sale should result.⁸⁰

The brief opinion in *Kavanagh v. Evans*⁸¹ concludes the analysis of the retained nonexclusive license question. In *Evans* the taxpayer retained at transfer a nonexclusive license to manufacture, sell, and use the patent, albeit limited to a particular field of use. Without mentioning the field of use restriction the court stated that it was permissible for the taxpayer to retain the nonexclusive license and still qualify for capital gain characterization: "It was entirely lawful for him to retain an undivided part or share of his exclusive patent rights."⁸² The reliance on the "undivided part or share" rule as the basis for permitting the retained license at least impliedly recognizes the applicability of the shared rights test.

Cases departing from *Evans*, such as *Allied Chemical Corp. v. United States*⁸³ and *Walen v. United States*,⁸⁴ also lend implicit support to the shared rights analysis of retained licenses. In both *Allied Chemical* and *Walen* the court denied capital gains treatment to taxpayers who retained a nonexclusive license at the time of the transfer. However, in each instance the transfer was disqualified not because of the retained license, but rather because the transferor retained some additional interest which did not satisfy the shared rights test.⁸⁵

In *Allied Chemical* the trial court flatly stated that the nonexclusive license retained by the transferor had value at the time of the transfer and therefore, under the retained rights test, no sale occurred as the "all substantial rights" rule was violated.⁸⁶ The Court of Appeals, however, carefully avoided resting its conclusion on this reasoning, focusing instead on the transferor's retained right to

79 *Charlson v. United States*, 36 A.F.T.R. 2d 5913 (Ct. Cl. trial opinion), *aff'd per curiam*, 525 F.2d 1046 (Ct. Cl. 1975); *Puschelberg v. United States*, 330 F.2d 56 (6th Cir. 1964). Note, as well, that a sale of a patent with the grantback of an *exclusive* license will be ignored as a mere device for converting ordinary income on future use of the patent into capital gain. *Gruber v. United States*, 158 F. Supp. 510 (D. Ore. 1958), *rev'd sub nom.*, *Mayer v. United States*, 285 F.2d 683 (9th Cir. 1960). The willingness of the court in *Gruber* to examine the net result of the transfers supports the hypothesis that a transferor's retention of a nonexclusive license does not preclude capital gain characterization. The Ninth Circuit later reversed the district court stating that a sale occurred at the precise time when the seller-partnership dissolved, transferring the bulk of its assets to a corporation. The result of the creation of the corporation was to separate the obligor under the exclusive license from the obligee under the original sale of the patent. 285 F.2d at 685.

80 See *General Aniline & Film Corp. v. Commissioner*, 139 F.2d 759 (2d Cir. 1944). *But see also Puschelberg v. United States*, 330 F.2d 56, 61 (6th Cir. 1964).

81 188 F.2d 234 (6th Cir. 1951).

82 *Id.* at 236.

83 370 F.2d 697 (2d Cir. 1967).

84 273 F.2d 599 (1st Cir. 1959).

85 *Bell* takes a somewhat contrary approach, viewing *Allied Chemical* and *Walen* as limiting or casting doubt on the proposition in *Evans* that a retained nonexclusive license does not in itself preclude capital gain characterization. 381 F.2d at 1014 n.4. *See also* 273 F.2d at 602 n.3.

86 *Allied Chemical Corp. v. United States*, 66-1 U.S.T.C. ¶ 9212 (S.D.N.Y. 1966), *aff'd*, 370 F.2d 697 (2d Cir. 1967).

compel the transferee to sublicense its interest for the transferor's benefit.⁸⁷ This power over sublicenses was not shared with the transferee; and as a result capital gain treatment was precluded. The Court of Appeals in *Allied Chemical* thus reached the result dictated by the shared rights test.

In a similar fashion the court in *Walen* distinguished *Evans* on the basis that in addition to the nonexclusive license retained by the transferor, the transferor also retained the right to prohibit the transferee from sublicensing his interest. Although the transferee had some right to restrict the transferor's sublicensing activities, the court found that the transferee's veto power was not equivalent to the powers retained by the transferor.⁸⁸ Stated in terms of the shared rights test, the power to restrict sublicenses was not shared and thus capital gain characterization cannot result. The effect of retained sublicensing restrictions on patent transfers is discussed in greater detail *infra*.⁸⁹

The identical shared rights analysis also resolves characterization questions arising from transfers of patents subject to other retained benefits. For example, although some courts have held that a sale will be denied where the transferor retains for himself a right to manufacture, in each instance the rights retained by the taxpayer were superior to those granted to the transferee;⁹⁰ the retained interests were not shared and therefore did not satisfy the shared rights test. Where the manufacturing right is shared, a sale results.⁹¹ Similarly, the right to sue for infringement may be retained by the transferor when the right is exercised for the mutual benefit of the transferor and transferee.⁹²

It is instructive to conclude this discussion of partial transfers by discussing one example where a proper application of the shared rights test would save a court from reaching an illogical result.⁹³ In *David R. Blake*⁹⁴ the court considered whether the transfer of a patent limited in field of use, *i.e.*, fragmented, would qualify as a sale under the all substantial rights test of § 1235. The court first determined that under the *Golsen*⁹⁵ rule the court was constrained to follow the Sixth Circuit's decision in *Fawick v. Commissioner*⁹⁶ which barred capital gain treatment for transfers of patents limited in field of use. *Blake*, however, involved two transfers, each limited to one of the only two valuable uses which the patent had. The court noted that *Fawick* would deny capital gain characterization to the transfer of the first fragment; but refused to apply *Fawick* to the transfer of the

87 370 F.2d at 699.

88 273 F.2d at 602.

89 See text accompanying notes 100-113 *infra*.

90 *E.g.*, in *Kirby v. United States*, 297 F.2d 466 (5th Cir. 1961), the taxpayer conveyed only the right to manufacture and *lease*, retaining to himself the exclusive right to manufacture and *sell*. In *Franz Martini*, 38 T.C. 168 (1962), the court found that *no* right to manufacture was ever conveyed to the transferee.

91 *Puschelberg v. United States*, 330 F.2d 56, 60-61 (6th Cir. 1964). See *Parke, Davis & Co.*, 31 B.T.A. 427 (1934); see also quotation at note 80 *supra*.

92 See *Watson v. United States*, 222 F.2d 689 (10th Cir. 1955); *Parke, Davis & Co.*, 31 B.T.A. 427 (1934).

93 Additionally, in *Watkins v. United States*, 252 F.2d 722 (2d Cir.), *cert. denied*, 357 U.S. 936 (1958), the court denied a sale based upon an extensive list of rights retained by the transferor, focusing to a substantial degree on the taxpayer's retained license.

94 67 T.C. 7 (1976).

95 *Jack E. Golsen*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971).

96 *Fawick v. Commissioner*, 436 F.2d 655 (6th Cir. 1971).

second fragment. Focusing exclusively on what the transferor retained the court determined that the taxpayer held nothing of value in the patent after the second field of use was transferred. Since the taxpayer transferred all of the substantial rights which he then held, a capital transaction under § 1235 occurred with respect to the transfer of the second fragment.⁹⁷ Thus, *Blake* reinterpreted *Fawick* to mean that no capital gain treatment will be granted transfers of fragmented patents, *except for the transfer of the last fragment*.

In this manner *Blake* is a classic illustration of the proverbial "distinction without a difference." There is no reason why the last fragment is conceptually different from the first fragment. A transferee receives exactly the same interest regardless of whether his field of use was carved out first or carved out last. Since the identical rights are transferred in each case, so must the characterization of the transfer be the same in each case.⁹⁸ The shared rights test would reach the result advocated by the Commissioner with respect to each and every fragment, first or last. When a fragmented patent is transferred the transferee does not receive at least some share of each and every right of the patent, therefore no sale will have resulted. *Blake* has been appealed to the Sixth Circuit Court of Appeals.

VI. Retained Burdens and the Shared Rights Test

Quite often, instead of retaining a visibly productive benefit, the right retained by the transferor will impose on the transferee some burden which potentially restricts the transferee's full use of the patent rights which he had obtained. As with retained benefits, retained rights analysis will ask if the burden retained by the transferor has value. The shared rights test, however, presumes the retained right to be valuable and asks instead whether a right reciprocal to the burden retained is held by the transferee. The shared rights test focuses exclusively on what the transferee receives. If a right equivalent to the burden retained by the transferor is held by the transferee then the transferee's rights are not subservient to those of the transferor and the transferee thus owns at least some part of each and every right of the patent. Alternatively, consider the right in question as held in common by both the transferor and the transferee, with both parties agreeing to restrict their exercise of that right.

Employing the *Bell* technique of real property concepts, a transfer of a patent subject to a burden is analogous to the transfer of real property subject to a restrictive covenant. Where the recipient can enforce a similar covenant against his neighbors it is clear that the transferee has lost nothing; in fact the value of his property is probably enhanced. In the case of patents as well, where the transferee owns rights equivalent to the burden retained by the transferor all rights to the patent are at least shared by the transferee. These rights may be shared in a negative sense; but they are shared nonetheless. The remainder of this article will address the reciprocal rights test: the shared rights test as applied to burdens.⁹⁹

⁹⁷ 67 T.C. at 16.

⁹⁸ See *Wiseman v. Barby*, 380 F.2d 121 (10th Cir.), *rev'd*, 390 U.S. 339, *reh. den.*, 390 U.S. 1036 (1967).

⁹⁹ The infamous *Dairy Queen* cases, involving transfers of franchises prior to the enactment

Probably the most common burden imposed in a patent transfer is to restrict the transferee's ability to sublicense or subassign the patent to others. Since most modern courts will apply the retained rights test of value, a "general rule" has developed that in normal circumstances the transferor's retention of a right to prohibit or restrict further sublicensing of the patent is not the retention of a right valuable enough to violate the all substantial rights test.¹⁰⁰ This general rule is uncomfortably applied, however, in that one is never quite sure as to what constitutes the abnormal circumstance where the retained right is indeed substantial.

By concentrating on value the courts are of course undertaking the wrong inquiry. The proper question is whether the transferee has received reciprocal rights to the burdens imposed on his interest. Under the shared rights test a sale will occur only in those circumstances where the transferee has a right to restrict the sublicenses of the transferor at least equivalent to the right which the transferor retained. If the transferee lacks such a reciprocal right then he lacks at least some share in all rights of the patent and no sale may result. All retained rights are presumed to be valuable; the true concern is whether such rights are reciprocal.

The germinal case in the area of sublicensing restrictions, *Parke, Davis & Co.*,¹⁰¹ articulates the shared rights analysis advanced throughout this article. In *Parke, Davis*, the Service argued that the transfer of certain patents was a license rather than a sale since the taxpayer retained, *inter alia*, the right to prevent a subsequent sale or sublicense of the patent, and, additionally, the transferor alone was permitted to bring suit for infringement of the patent. The court stated that the retention of these rights would normally prevent a "sale." However, since in this particular case the retained rights were held in common between the transferor and the transferee, a sale nonetheless resulted:

It is true that a right to sell the invention or to grant to others a license was not transferred to Lilly, but petitioner by the agreement surrendered the right to exercise these privileges without Lilly's consent, so that its rights in this respect were no greater than those of the latter. *Upon execution of the agree-*

of § 1235, may also illustrate the shared rights test. Although the cases are difficult to reconcile, the courts generally permitted capital gain characterization where the rights retained by the transferor were designed to promote and preserve the quality of the product, thereby benefitting all the franchise holders. *See, e.g.,* Moberg v. Commissioner, 310 F.2d 782 (9th Cir. 1962); Estate of Gowdey, 307 F.2d 816 (4th Cir. 1962); Dairy Queen of Oklahoma v. Commissioner, 250 F.2d 503 (10th Cir. 1957). *Cf. Conde Nast Publications, Inc. v. United States*, 575 F.2d 400 (2d Cir. 1978) (restrictions designed to protect the trade name in a retained field of use did not negate a sale).

However, the courts denied capital gain treatment if the rights retained by the transferor appeared to be for his individual benefit. *See, e.g.,* Resorts Int'l v. Commissioner, 511 F.2d 107 (5th Cir. 1975); United States v. Wernentin, 354 F.2d 757 (8th Cir. 1965); Walter T. Roob, 50 T.C. 891 (1968); *see also*, Leisure Dynamics, Inc. v. Commissioner, 494 F.2d 1340 (8th Cir. 1974). *Cf. Consolidated Foods Corp. v. United States*, 569 F.2d 436 (7th Cir. 1978) (where consideration involves no lump sum payment but is entirely in the form of royalties, no capital gain treatment will result).

¹⁰⁰ *See, e.g.,* Rollman v. Commissioner, 244 F.2d 634 (4th Cir. 1957); Lawrence v. United States, 242 F.2d 542 (5th Cir. 1957); Watson v. United States, 222 F.2d 489 (10th Cir. 1955); Arras v. United States, 164 F.Supp. 150 (D. Conn. 1958); Glen O'Brien Moveable Partition Co., 70 T.C. 492 (1978); Newton Insert Co., 61 T.C. 570 (1974), *aff'd per curiam*, 545 F.2d 1259 (9th Cir. 1976); William W. Taylor, 29 T.C.M. 1488 (1970); *see also* Treas. Reg. § 1.1235-2(b)(3)(i).

¹⁰¹ 31 B.T.A. 427 (1934).

ment neither had the right to sell or license without the permission of the other. . . . It is true that petitioner retained the legal title to the patents as well as any future improvements thereon and alone could sue for their infringement, but such suit was to be for the benefit of both, its cost to be borne equally by the two and any judgment secured for the infringement was the property of the two in equal proportions. As a result of these conditions we can see no more than the retention by petitioner of the naked legal title in the interest and for the benefit of itself and Eli Lilly & Co. as the joint owners in equal proportions of the entire beneficial interest in the patents and improvements thereon.¹⁰²

Significantly, the actual agreement did not appear to expressly mention that the parties were to own all rights in equal proportions. Nonetheless, the court ruled that since those rights retained by the taxpayer had also been granted to Lilly, the transferee, there was joint ownership of the rights and a sale had been effected. In other words each right retained by the transferor was also at least shared by the transferee, and the all substantial rights test was thereby met.

Parke, Davis is followed in importance by the Fourth Circuit's decision in *Rollman v. Commissioner*.¹⁰³ In that case the taxpayers transferred their patent and, in order to protect the value of their royalty, required that the transferee obtain their written consent before granting any sublicenses. Two rationales were employed by the court to reach the conclusion that the retained right to prohibit sublicenses was not a substantial right. On the one hand, the court reasoned that since the transferor had no rights in the patent itself, the transferor also could not grant sublicenses without the transferee's consent.¹⁰⁴ In other words the restriction on sublicensing was shared within the rationale of *Parke, Davis & Co.* (and the reciprocal rights rule) and therefore did not defeat a sale. Such reciprocal rights reasoning alone is sufficient to reach the result in *Rollman*.

The court, however, also employed an alternative basis for reaching its conclusion: The transferor conveyed all substantial rights in the patent because the right to sell the patent is not a substantial right of the patent: "Such a limitation does not interfere with the full use of the patent by the [transferee] and its serves to protect both parties to the assignment in case the purchase price is paid in installments."¹⁰⁵

Rollman's implication that a restriction against sublicensing will never be the retention of a substantial right is without foundation once a transaction falls outside the reciprocal obligations which existed in the specific case of the *Rollman* transfer. Although not a right peculiar to a patent, the right to sell to another is inherent in the general nature of the ownership of property, and therefore a right which should normally be conveyed before a patent can be considered to have

102 *Id.* at 430-31.

103 244 F.2d 634 (4th Cir. 1957).

104 *Id.* at 640. *Newton Insert Co.*, 61 T.C. 570, 580 (1974), *aff'd per curiam*, 545 F.2d 1259 (9th Cir. 1976) (failure to grant the right to sublicense does not defeat a sale, i.e., constitute the reservation of a substantial right, since the transferor was foreclosed from granting other licenses by the exclusiveness of the transferee's license). *William W. Taylor*, 29 T.C.M. 1488 (1970) (the transferor was also precluded from making assignments himself; therefore a sale occurred).

105 244 F.2d at 640.

been "sold."¹⁰⁶ By failing to limit its holding to the reciprocal rights rule employed by the court in *Parke, Davis & Co., Rollman* created the potential for taxpayer abuse in situations of restricted rights to sublicense which in practical impact are not reciprocal and not for the mutual benefit of both parties. For example, the *Rollman* presumption in favor of the insubstantial nature of the retained right clearly does not apply to instances where the transferor also retains an undivided interest in the other rights of the patent. Without a reciprocal restriction on the transferor's right to sublicense, the net effect of the retained interests is a grant of a mere nonexclusive license.

*Jacques R. Milberg*¹⁰⁷ reached this exact conclusion based on slightly more complicated facts. At the time of the transfer in question two undivided one-half interests were outstanding in the patent. One of these undivided interests was transferred, with the grantor reserving a termination provision less than the life of the patent, and further imposing a clause which prohibited the transferee from assigning or sublicensing his interest. Although the termination provision alone was sufficient to negate a sale, the court also determined that the effect of the sublicense bar was to limit the transferee's rights to a nonexclusive sublicense. Even though the grantor by himself could not grant further licenses, the grantor and the owner of the other one-half interest could. The court therefore viewed the sublicensing restriction as the retention of a continuing beneficial interest by the grantor, since the grantor and the other owner could receive additional royalties through sublicenses of the remaining one-half interest.¹⁰⁸

The better analysis looks only at the transferee. The prohibition against assignment imposed by the grantor was not coupled with a reciprocal right permitting the grantee to prohibit sublicenses of the remaining one-half interest. The transferee did not own at least some part of all of the rights of the patent and therefore no sale occurred.

A similar conclusion was reached in *Walen v. United States*¹⁰⁹ where further sublicenses were contemplated by the transferor on its interest, while the transferee was prohibited from sublicensing. Although the agreement granted the transferee a veto power over further licenses by the transferor, the court determined that this veto power was not absolute, and not equivalent to the sublicensing restriction retained by the transferor.¹¹⁰

106 *Jacques R. Milberg*, 52 T.C. 315 (1969). See *Cubic Corp. v. United States*, 72-1 U.S.T.C. ¶ 9165 (S.D. Cal. 1971), *aff'd*, F.2d (9th Cir. 1974); see also *Edward W. Reid*, 50 T.C. 33 (1968); *Commercial Solvents Corp.*, 42 T.C. 455 (1964), *acq.*, 1965-1 C.B. 4 (both involving transfers of trade secrets).

107 52 T.C. 315.

108 *Id.* at 318-19.

109 273 F.2d 599 (1st Cir. 1959).

110 *Id.* at 602. Consider as well the case of *Edward W. Reid*, 50 T.C. 33 (1968), which involved a transfer of a secret formula subject to an obligation that the transferee would not disclose the formula to anyone else; in other words, the transferee could neither assign nor sublicense the secret. The court denied capital gain treatment stating: "This striving for secrecy . . . indicates that [the transferor] intended to preserve its property rights in the trade secret for possible future use—an intent which is consistent only with a license, not a sale." *Id.* at 41. Of critical importance to shared rights analysis is footnote 6 of the court's opinion which commented that although the transferor was also subject to nondisclosure provisions, these provisions were not for permanent nondisclosure. *Id.* In other words, the disclosure limitation was not shared *equally*, and therefore no sale could have occurred.

In *Commercial Solvents Corp.*, 42 T.C. 455 (1964), *acq.*, 1965-1 C.B. 4, another trade

The Tenth Circuit's recent decision in *Eickmeyer v. Commissioner* further illustrates how the courts will realistically examine whether the sublicensing right is shared or retained for the predominant benefit of the transferor. Where the transferor's retained right to sublicense is effectively superior to the transferee's right to sublicense, capital gain characterization will be denied.¹¹¹ In similar fashion, when the transferor can compel the transferee to create sublicenses once again a license rather than a sale results because the right to create, or not to create, additional licenses is not shared by the transferor and transferee.¹¹²

Even when the transferor has otherwise parted with all rights in the patent, the mere retention of a sublicensing restriction can still violate the shared rights test. Consider for example the following international setting: USA Corp. owns patents (on a particular invention) in countries A, B, C, and D. USA transfers all rights in the D patent to FORCO, retaining only the right to prohibit FORCO from further sublicensing or assigning the D patent. Since USA retains patents on the invention, the retention of the right to prohibit FORCO from sublicensing is the retention of a valuable and substantial right in the D patent. Since the invention is patented only in A, B, C, and D, any corporation with access to the technology is free to compete in all those countries where there is no outstanding patent on the invention. Since FORCO cannot sublicense the D patent, FORCO's rights in the invention are subordinate to USA who can create additional owners in A, B, and C, owners who, once established in their own markets, can economically compete with FORCO in the unpatented territories. By retaining to itself the exclusive right to create additional owners who can readily compete in unpatented countries, USA has retained a substantial right in the D patent which is not shared with FORCO. The restraint on sublicensing is not for the mutual benefit of both parties, as was the case in *Rollman*, but for the exclusive benefit of USA. Since FORCO cannot restrain the sublicensing of

secret case, the court also found that a prohibition on assignment coupled with the inability of the transferee to prohibit further disclosures by the transferor required the conclusion that only a license had been effected. *See E. I. DuPont de Nemours & Co. v. United States*, 288 F.2d 904 (Ct. Cl. 1961); *Stalker Corp. v. United States*, 209 F. Supp. 30 (E.D. Mich. 1962).

111 580 F.2d 395 (10th Cir. 1978). In *Eickmeyer* the taxpayer sought to sell undivided one percent interests in his patent rights claiming capital gains treatment on his profits. The agreement was so structured that although each transferee could sublicense his interest, he could not do so without the proceeds of the sublicense flowing upward to the transferor. The court determined that this arrangement effectively precluded any sublicensing of the interests. Consequently, the court denied capital gains treatment based upon Eickmeyer's retention of "the all-important right to collect for all uses of the patent whether by the original transferee or subsequent ones." *Id.* at 399. The court found that such control over sublicenses, coupled with the number of interests carved out of the patent, created in practical effect nonexclusive licenses which failed to satisfy the all substantial rights test. "The unlimited power enjoyed by Eickmeyer to create new licenses or owners also serves to reveal the true character [the grant of only a nonexclusive license] of his property interest." *Id.* at 400.

The rationale of *Eickmeyer* can be stated more elegantly by applying the reciprocal rights rule. The transferees had no reciprocal right to limit the sublicenses granted by Eickmeyer. Eickmeyer thereby retained a valuable right in the patent which was not reciprocally granted to his transferees. In so retaining solely to himself the sublicensing right, Eickmeyer failed to satisfy the reciprocal rights rule and as a result breached the "all substantial rights" requirement of section 1235. *See also Hagen, Are Capital Gains Still Available via Patent Fragmentations? A Current Analysis*, 43 J. TAXATION 78 (1975) (discussing the possibility of maximizing capital gains through the sale of undivided interests). *See generally Leubsdorf v. United States*, 164 F. Supp. 234 (Ct. Cl. 1958).

112 *Allied Chemical Corp. v. United States*, 370 F.2d 697 (2d Cir. 1967); *see Schmitt v. Commissioner*, 271 F.2d 301 (9th Cir. 1959).

the invention by USA, as it could in *Rollman*, no reciprocal rights have been created and the all substantial rights requirement has not been satisfied. Arguably, however, at least one court has reached this very result.¹¹³

One should be aware that in the international setting reciprocal restrictions on sublicensing may satisfy the tax law, but also create problems with respect to U.S. antitrust laws, particularly when combined with territorial market allocations.¹¹⁴ Coincidentally, attempts by sellers to avoid the antitrust implication that they are dividing world markets has created a new retained right, the retained import right, which under the retained rights test of value creates immediate problems for the seeker of capital gains.

United States antitrust law, as applied to foreign commerce, may require a U.S. transferor of a patent to retain for himself the right to import into the transferee's country. Since a patent customarily grants exclusive manufacturing and selling rights within the country of the patent, the Service is quick to challenge the retention of such a right to import as the reservation of a substantial right in the patent violative of the all substantial rights test. The court, under the retained rights test, is then forced to evaluate the economic value of the retained import right. Where the right has clear value the seller's compliance with the antitrust law precludes him from ever selling his patent for a capital gain.¹¹⁵

The case of *Hooker Chemicals and Plastics Corp. v. United States* illustrated this very dilemma.¹¹⁶ In that case Hooker entered into an agreement with two foreign corporations for the transfer of patents and related technology concerning certain chemical processes. Some patent rights were transferred to each corporation so that each had its own exclusive sales territory, while other patent rights governing a specific territory were transferred to be held in common by the two corporations. In order to preclude a challenge that it was illegally dividing world markets (the facts can be viewed as generally approximating the famous *Timken Roller Bearing*¹¹⁷ case), Hooker retained to itself the right to import into the transferees' geographic territories. Hooker granted reciprocal import rights to its

113 In *Oak Manufacturing Co. v. United States*, 301 F.2d 259 (7th Cir. 1962), foreign patent rights were transferred subject to a number of restrictions including the bar to further assignments and the reservation by the transferor of the right to apply for patents in other countries. The court intuitively recognized that the transfer was more in the nature of an agency relationship than the execution of a sale of patent rights. However, the retained rights condemned by *Oak* were all rights customarily permitted transferors in the domestic setting, e.g., the sublicense bar and the right to control infringement suits. See, e.g., *Parke, Davis & Co.* discussed in the text accompanying notes 101-107 *supra*.

Although the result in *Oak* is perplexing when viewed entirely from traditional retained rights tests, the court's conclusion is readily understood when compared with the USA-FORCO agreement discussed in the text. See *Continental Carbon Co. v. United States*, 37 A.F.T.R. 2d 318 (S.D. Tex. 1975), where the transferor's competition with the transferee in world markets, coupled with a sublicensing restriction imposed upon the transferee's patent, precluded sale treatment.

But see *E. I. DuPont de Nemours & Co. v. United States*, 432 F.2d 1052, 1056 (3d Cir. 1970) where the court mechanically applied *Rollman* to an international transfer of patent rights.

114 See W. FUGATE, *FOREIGN COMMERCE AND THE ANTITRUST LAWS* (1973).

115 See J. BISCHER, *TAXATION OF PATENTS, TRADEMARKS, COPYRIGHTS AND KNOW-HOW* 1-9 to 1-10 (Supp. 1976) where the argument is made that the retained rights test should yield to the antitrust laws, at least in some circumstances.

116 42 A.F.T.R. 2d 5231 (Ct. Cl. trial opinion 1978).

117 *Timken Roller Bearing Co. v. United States*, 341 U.S. 593 (1951).

transferees.¹¹⁸ The Service sought to deny Hooker capital gains treatment of the transfer under § 1222(3) based in part upon the retention of this import right which the Service claimed to be substantial.

The determination of the import issue resolved to a factual question of whether the import right was substantial; did the right have substantive economic value? The court found that the right had no practical value and therefore was not a substantial right retained by the transferor. The court noted that due to prohibitive shipping costs it was not feasible for Hooker to compete with its transferees in their countries. The court further found that only the foreign transferees could provide foreign purchasers the technical assistance necessary for the purchaser to use the product. Finally, the court buttressed its conclusion by the Service's own concession that Hooker rarely exercised its import right, and when it did, it did so only at the request of the transferees themselves.¹¹⁹

The court in *Hooker* reached the correct result only after a painstaking factual analysis of value. The reciprocal rights test resolves *Hooker* in a single paragraph: Hooker transferred all substantial rights in the patents with the sole exception of the retained right to import from the United States into the transferee's countries. In exchange for this retained right Hooker granted its transferees the reciprocal right to import from their countries into the United States. Since the import rights were thus shared, each transferee received at least some part of each and every right of the patent, and the all substantial rights test had been satisfied.

Most importantly, the reciprocal rights rule eliminates all questions of value and thereby eliminates the dilemma which forces the seller to choose between the tax law and the antitrust law. Unlike the facts as found in *Hooker*, corporations will often own patents on products that can readily be exported economically. In such an instance a retained import right will be of clear value, and, therefore, under the retained rights test no sale can be completed except by risking a violation under the antitrust laws. However, if in retaining the import right the transferor also conveys to the transferee the right to import into his own country, then selling rights are shared, and, under the reciprocal rights test, all substantial rights have been transferred. The value of the right is entirely irrelevant to this inquiry; indeed the shared rights test presumes the import right to be valuable. Rather, the question is only whether the rights are in fact equivalent or reciprocal.¹²⁰

118 42 A.F.T.R. 2d at 5233.

119 *Id.* at 5234-36.

120 Where each party has the right to sell throughout the entire territory of the other, it would seem that in almost every circumstance rights will be reciprocal. However, one can envision a contrary result if the transferor may sell throughout the territory of the transferee, but the transferee has import rights limited to but one of many countries in which the transferor holds patents. It would seem logical that if the transferor's import rights were limited to goods originating from one country, assume for example the United States, then a reciprocal import right granted to the transferee limited to the United States would nonetheless be reciprocal in the sense of creating "in common" ownership within the meaning of the grant of an undivided interest. However, such a right to import limited to the United States would not be reciprocal where the transferor could import into the transferee's country from anywhere in the world. Further complications result if one of the countries from which the product originates is not a consumer of that product.

Illustrating that some analysis may be required before the reciprocal rights test is applied

VII. Is the Shared Rights Test Exclusive?

Finally, this article has repeatedly implied that the shared rights test is the exclusive test of capital gain for patent transfers. It has been presumed that a right, if retained, is substantial; otherwise the grantor would not have bothered to retain it. Consequently, not only does the shared rights test state that a sale will result if retained rights are all shared (and all substantial rights to the patent are otherwise transferred); but the test also states that if a retained right is not shared no sale can result. In highly unusual circumstances, however, the presumption of value may be rebutted and this latter conclusion will not necessarily follow.

*E. I. DuPont de Nemours & Co. v. United States*¹²¹ (1970), is the only known case in the patent field justifying an "exception" to the shared rights test. DuPont, in order to satisfy what it believed to be the requirements of an antitrust decree, retained the right to import into Brazil upon its sale of a Brazilian patent. Apparently DuPont granted no reciprocal import right to its transferee. The court held the retained import right to be insubstantial based upon Brazilian trade law. Since the transferee was a Brazilian company the parties expected the Brazilian government to bar DuPont from importing into Brazil in competition with its transferee; and in fact the Brazilian government so acted. As a result the import right was without value and a sale had been executed.¹²²

Three comments should be made about this "exception" to the shared rights test: (1) The right retained by DuPont was "given back" to the buyer by local law and governmental practice. In actual fact, DuPont retained no legal rights in the patent, and even the shared rights test is satisfied. (2) The right was retained pursuant to compliance with an antitrust decree. Thus DuPont by its own act of retention did not indicate the right to be of substantial value. (3) And finally, given Brazilian practice of barring imports, it was most likely impractical from a business standpoint to grant the transferee a reciprocal right without such a large adjustment in royalty as would render the agreement unattractive from the standpoint of the buyer. Consequently, if DuPont represents an exception to the shared rights test, it is certainly a limited one.

To conclude, as noted earlier, a transfer of an asset should be granted capital gain treatment depending upon the property characteristics of the asset transferred. An analysis of the legal relationships of the rights conveyed, not an economic assessment of the rights retained, is necessary if the property characteristics of an asset are to be properly evaluated. The shared rights test accomplishes such a property analysis; the retained rights test does not.

is the case of *Commercial Solvents Corp.*, 42 T.C. 455 (1964), where the court determined that a transfer of trade secrets did not implement a sale where, among other rights, the transferor retained the right to import into the transferee's country.

¹²¹ 432 F.2d 1052.

¹²² *Id.* at 1055-56.