

PATENTS AND THE FEDERAL INCOME TAX LAWS

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THE maxim has often been repeated, with more enthusiasm for publicity than precision, that while one cannot "evade" taxes, one may adopt any device to "avoid" taxes which lies within the Congressional mandate. Many words have been written about the nebulous line between "evasion" and "avoidance";^{1*} yet all tax authorities agree that tax saving as such is a legitimate object of endeavor.

In the field of patents, there are several places where tax savings may be effected. This article will endeavor to point these out, and fit them within a general discussion of the Federal income tax laws as they affect patents.

There is a usual chronological pattern that business dealings with patents assume: first, the acquisition or development of the patent; then a holding period during which certain expenses are incurred; and finally the disposition of the patent either by sale or through the economic processes which completely destroy its value. The article will discuss the tax consequences of each step in the order given.

I. Acquisition or development

If a taxpayer purchases an already issued patent from some third person, the purchase price is, of course, not deductible in the year in which the purchase is made, any more than would the purchase price paid for a business or shares of stock be deductible. Such expenditures are capital investments, and form the cost, or, in the technical language of the income tax laws, the "basis", of the object purchased. Then, later, when the object is sold, the cost or "basis" is subtracted from the selling price, and the difference is taxable income. As we shall see, in the case of patents, provision is made for deducting as depreciation in each year during the remaining life of the patent a proportionate part of its costs of "basis" (see Section IIA below).

A similar result obtains if a taxpayer, by dint of his own efforts and ingenuity, actually develops a patentable invention himself. His cost of materials and labor, his expenses in clearing title and filing an application for a patent, his Government fees, his costs in any interference proceedings that may arise while his application is pending, are all part of his total cost.² The value of the individual's own time, however, is excluded. This total cost corresponds to his cost, or "basis", had he purchased an already issued patent from a third party. And the treatment thereof is the same: when the patent is sold, this cost, less depreciation, is subtracted from the selling price to ascertain the amount of taxable income.

Where, however, a corporation is formed to produce a patented article, the salary and organization expenses may not be considered as part of the cost, and must be treated as deductible expenses.³

*References are given at the end of the article.

If, in the case of the taxpayer who develops his own invention, his application for a patent eventually meets with failure, it seems safe to assume that the expenses incurred therewith may be deducted as a loss in the year in which the patent application is denied.⁴

II. The holding period

A. **Depreciation.** When a taxpayer is granted a patent, he is the recipient of an exclusive monopoly to exclude all others from the field covered by his patent for a period of seventeen years. At the end of this period, the patented invention is open to public use. Thus, to receive a patent is to secure a property right for a limited time only. In this respect, holding a patent corresponds to owning a building which has a useful life of only a limited number of years. In both cases, a deduction is allowed in each year the asset is held, in an amount representing the value of the asset which can be considered to have been lost during that year. This normal deduction for what might be called the exhaustion of the value of property is computed by taking the total cost of the property and spreading it out over its expected life. In the case of a patent, this means allocating 1/17 of the cost to each year, commencing with the year the patent is granted.⁵

In connection with this deduction for depreciation, there are several important points:

(1) The depreciation must be taken on the basis of the legal life of the patent, the full seventeen years, even though it is reasonably felt but not conclusively shown that the useful life of a patent may be for a shorter period.⁶

(2) The depreciation deduction is not allowed during the period when an application is pending, but commences only in the year when the patent is granted.⁷

(3) Where there are several patents dependent upon a basic patent, depreciation on these ancillary patents is allowed on the remaining life of the basic patent.⁸

(4) If depreciation is not taken in the early years of a patent, this will not be considered a binding election; depreciation may be taken later, but its annual amount will be computed as if the deduction been had taken over the entire life of the patent.⁹

(5) Where a patent is acquired by bequest, devise or inheritance, the depreciation deduction will be taken on the value of the patent as of the date of the decedent's death, and spread out over the remaining legal life of the patent.¹⁰

B. **Obsolescence.** As has been stated, depreciation is allowed as a deduction to the owner of a patent, based on its legal life of 17 years. If, however, unforeseen circumstances, such as scientific progress, changed economic conditions, legislation, or similar

elements, make it apparent that the useful life of a patent will be cut short of its legal life, a deduction in addition to depreciation may be taken in order to accelerate the writing off of the cost of the patent.¹¹ This increased deduction is referred to as obsolescence. As an example, if after seven years it is discovered that a patent costing \$17,000, for which an annual depreciation deduction of \$1,000 is taken (\$17,000 divided by 17 years), will have a remaining useful life of only five years, the remaining depreciated cost of \$10,000 (\$17,000 less \$7,000) may be written off in the remaining five years by adding to the \$1,000 depreciation deduction an annual deduction for obsolescence of an additional \$1,000. Thus, in the given example, the result will be that at the end of 12 years the entire cost of the patent will have been written off, and this will coincide with the then zero value of the usefulness of the patent.

(This deduction for obsolescence is to be distinguished from the loss occasioned by complete and sudden abandonment of a patent, as to which see Section IIIB below).

C. Infringement proceedings. After a patent is issued, and articles have been manufactured, used, or sold thereunder, it may unfortunately develop that other persons than the owner feel that the patent infringes upon one already issued. Legal¹² and accounting¹³ fees paid by a defendant in an infringement suit are generally deductible in the year paid,¹⁶ although current authorities concede that no hard and fast rule may be made.¹⁵ Damages paid pursuant to judgment are also deductible,¹⁶ but only in the year when the judgment is rendered.¹⁷ Amounts paid in settlement of an infringement suit, although not pursuant to judgment, are also deductible items.¹⁸

Where the patent owner is the plaintiff in an infringement suit, and claims that others are infringing on his patent, damages recovered by him are income when received,¹⁹ against which of course he is allowed to deduct his legal and accounting costs. Where, however, the individual buys a patent and with it the right to damages in a suit then pending, the ultimate receipt of damages will not constitute income, since the right to damages was part of the purchase price.²⁰

III Disposition

A. By sale

1. **Capital gain.** Where an individual is not an inventor by profession, and where sale of a patent can not be construed as disposition of "stock in trade", any income received as proceeds on the sale of a patent is a capital gain.²¹ If the invention has been put into practice or the patent has been granted longer than six months prior to sale,²² the gain will not be taxed, regardless of the income tax bracket of the individual as to his other income, at a higher rate than 25 per cent.

2. **Installment sales.** Where the taxpayer is in the business of selling patents, or where the taxpayer makes a casual sale of a patent and (1) the price is more than \$1,000 and (2) the initial payments do not exceed 30 per cent of the selling price, it may be profitable, under certain circumstances, to elect to treat income received on an installment sales basis.²³ On this basis, the profits from a sale may be taxed over the period of years covered by the installment payments based upon the amount of profit which is realized from each such payment. To illustrate, if

the depreciated basis of a patent is \$5,000 at the time of sale, and the selling price is \$10,000, this means that for every dollar received by the seller, 50 cents or 50 per cent is profit. Accordingly, if the contract of sale provides that \$2,000 will be paid immediately, and the balance of the purchase price will be paid in four equal annual installments of \$2,000, and if the seller finds it advantageous to do so, he may elect to report this transaction on the installment sales basis. On this basis, of the \$2,000 received in the year of sale and in each of the succeeding four years, only \$1,000 will be reported as taxable income in each year. The tax saving can be made very substantial in appropriate cases by the use of this method, and contract terms should be carefully drawn to allow the method to become operative where desired.

3. **Compensation for work covering 36 months or more.** Until recent years, inventors who worked for long periods of time without pay and then received their full compensation upon the completion of their undertaking were taxed fully in the year in which payment was received. This resulted in two inequities: (1) only the deductions, credits and expenses of the final year were chargeable against the compensation for the full period, and (2), by reason of the graduated surtax, the taxpayer was subjected to a greater tax burden than he would have incurred had the compensation been spread out over a number of years. Accordingly, the 1942 Revenue Act sought to correct this situation for inventors, authors, composers and the like, by enactment of Section 107 (b) of the Internal Revenue Code, effective for taxable years beginning after December 31, 1941, which reads as follows:

"(b) Patent, Copyright, Etc.—For the purposes of this subsection the term "artistic work or invention", in the case of an individual, means a literary, musical, or artistic composition of such individual or a patent or copyright covering an invention of or a literary, musical or artistic composition of such individual, the work on which by such individual covered a period of thirty-six calendar months or more from the beginning to the completion of such composition or invention. If, in the taxable year, the gross income of any individual from a particular artistic work or invention by him is not less than 80 per centum of the gross income in respect of such artistic work or invention in the taxable year plus the gross income therefrom in previous taxable years and the twelve months immediately succeeding the close of the taxable year, the tax attributable to the part of of such gross income of the taxable year which is not taxable as a gain from the sale or exchange of a capital asset held for more than six months shall not be greater than the aggregate of the taxes attributable to such part had it been received ratably over that part of the period preceding the close of the taxable year but not more than thirty-six calendar months."

Stripped of its legal phraseology, this Section is interpreted to mean that, in the case of work done by an individual on a patented invention covering a period of 36 months or more, the tax on income received in a given tax year from the invention shall not be more than the total taxes would have been, had the income been received ratably over (1) the period representing that part of the work which had been completed prior to the close of the taxable year, or (2) a period of 36 months, whichever of such

periods is the shorter. This ceiling on the tax to be paid becomes effective only if the income received on an invention in the taxable year is 80 per cent or more of all amounts received in prior years, in the taxable year, and in the 12 months next succeeding the taxable year. This Section does not apply to income received as a long-term capital gain, which, as has been shown above, already has a 25 per cent ceiling.

A series of examples will illustrate the operation of this Section. In each example, it will be assumed that A is an individual who makes his returns on a calendar year basis, and on the basis of cash receipts and disbursements, and that he is not in the business of selling inventions (i.e., the long-term capital gains provisions do not apply).

(1) On October 1, 1942, A receives a down payment of \$1,000 on the sale of a patent, the work on which was commenced on September 1, 1940, and will be completed on January 31, 1944. Further installments are due in equal amounts for the next five years following 1942. This is not the kind of case fitting within Section 107 (b), since less than 80 per cent of all amounts paid will have been received in any one taxable year.

(2) On November 30, 1943, A receives \$36,000 in full payment for the sale of a patent the work on which was commenced on September 1, 1940, and will be completed on January 31, 1944. This is the kind of case covered by Section 107 (b), since in the taxable year 1943 A receives at least 80 per cent of the total payments to be made. Accordingly, the tax attributable to the \$36,000 received in 1943 shall not be greater than the tax attributable to such an amount, had it been received ratably over the calendar months from September 1, 1940 to December 31, 1943 (the close of the taxable year in which work was performed). The specific allocation to each year of the \$36,000 received will be as follows: The period of work covers 41 calendar months, but allocations can be made to only the last 36 calendar months which precede the close of the current taxable year. Therefore, \$1,000 (\$36,000 divided by 36) must be allocated to each of the calendar months preceding January 1, 1944. Accordingly, \$12,000 is allocated to 1941, \$12,000 to 1942, and \$12,000 to 1943.

(3) Assume the same facts as in Illustration 2, except that work was commenced on July, 1942, and will be completed November 30, 1945. Although the period of work covers 41 calendar months, allocations may be made to only the 18 calendar months which are included within the part of the period of work which precedes the close of 1943 (the current taxable year). Therefore, \$2,000 (\$36,000 divided by 18) must be allocated to each of 18 calendar months preceding January 1, 1944. Accordingly, \$12,000 is allocated to 1942, and \$24,000 to 1943.

(4) On November 30, 1945, A receives the sum of \$36,000 in full payment for the sale of a patented invention the work on which was commenced on September 1, 1942 and completed on October 1, 1945. Although the period of work covers 37 calendar months, allocations may be made to only the 36 calendar months preceding the date of completion of the work. Therefore, \$1,000 (\$36,000 divided by 36) must be allocated to each of the 36 calendar months preceding October 1, 1945. Accordingly, \$3,000 is allocated to 1942, \$12,000 to 1943, \$12,000 to 1944, and \$9,000 to 1945.

(5) Assume the same facts as in Illustration 4,

except that payment was made on January 1, 1946. Here payment was made in a taxable year other than the one within which work was completed. This nonetheless appears to be the kind of case covered by Section 107 (b). Accordingly, the tax attributable to the \$36,000 received in 1946 shall not be greater than the tax attributable to such an amount, had it been received ratably over the calendar months during which the work was performed, not to exceed 36 months. The specific allocation would therefore be as follows: \$3,000 in 1942, \$12,000 in 1943, \$12,000 in 1944, and \$9,000 in 1945.

Once specific allocation has been made, pursuant to Section 107 (b), it becomes necessary to determine the tax attributable to the income in the year received; this tax cannot be greater than the total of the taxes which would have been paid on this income, had it been allocated over earlier years. This determination is made in the following manner:

	Total tax in current taxable year, including all income from invention
Line 1	Less: Tax in current taxable year, excluding income from invention
Line 2	Tax attributable in current taxable year to income from invention
	Total tax in current and prior year, including allocated income from invention
	Less: Tax in current and prior taxable years, excluding allocated income from invention
Line 3	Total tax payable, had income from invention been allocated

The tax payable in the current taxable year is the sum of Line 1 and the smaller of Lines 2 and 3.

A recent ruling²⁴ of the Income Tax Unit, Treasury Department, provides that Section 107 (b) contemplates that expenses incurred in earning income should be treated as if ratably paid over the same period as that in which the income was earned. This ruling will affect the computation given above.

B. By Abandonment

The Internal Revenue Code²⁵ makes certain distinctions based upon whether or not an asset is a "capital asset". One of these distinctions has already been noted, namely, the ceiling of 25 per cent on the tax accruing upon the sale at a gain of a capital asset held for longer than six months. Other distinctions are made where the capital asset is sold at a loss, one of which is that in the case of an individual, only 50 per cent of the loss can be deducted where the asset has been held for a period longer than six months.

Where, however, there is disposition not by sale but by abandonment, the Internal Revenue Code makes no distinctions as to whether the asset is or is not a capital asset. A deduction is allowed for the full loss.²⁶

To constitute abandonment, there must be an intent to abandon, coupled with some decisive act evidencing this intent.²⁷ The cause of abandonment must be some sudden event which prematurely and unexpectedly terminates the useful life of the asset.²⁸ In the case of a patent, this could be caused by, for example, a war making it impossible to procure ingredients necessary to manufacture the patented article. This loss for abandonment is fully deductible

only in the year of actual abandonment.²⁹ It is distinguishable from depreciation, in which it is considered that the asset gradually wastes away during its expected life, and from obsolescence, in which the expected life is shortened but not completely terminated.

It is settled that the deduction for loss by abandonment applies to both patents³⁰ and patent rights.³¹ A question has arisen as to whether there may be some residual value to the abandoned patent, or whether there must be a complete uselessness before the loss may be allowed.³² Early cases have expressed the view that there can be no residual value.³³ However, the present Treasury Department Regulations appear to contemplate an abandonment loss where there may yet be some salvage or scrap value to the patent abandoned.³⁴ The question becomes acute where a patent is "sold" for its scrap or salvage value. Is this a sale or exchange, such that, if appropriate, the capital loss limitations apply? Or is this an abandonment of all but the residual value, such that a full loss, less the salvage value recovered, is deductible? There is no clear-cut answer to this question, although it would appear to be a fully deductible loss where the taxpayer writes down the depreciated cost of the patent on his books to its present estimated salvage value, and in a separate—though almost simultaneous—transaction, sells it for its scrap or salvage value.³⁵

IV Conclusion

Tax avoidance, which the author likes to refer to as tax "savings", is a legitimate realm within which the ingenuity of an individual may be translated into actual dollars. Particularly with respect to installment sales and compensation for work performed on an invention for a period of 36 months or more, a taxpayer has the opportunity to effect tax savings for himself which should not be overlooked.

1. Buck, "Income Tax Evasion and Avoidance; Some General Considerations," 25 Georgetown, L. J. 863 (1937); Angell, "Tax Evasion and Tax Avoidance", 38 Co. L. R. 80 (1938)
2. Addressograph-Multigraph Corp., TC Memo Op., Dec. 14, 1937 (M); Claude Neon Lgts, Ins., 35 BTA 424; Buffalo Forge Co., 5 BTA 947; Gillian Mfg. Co., 1 BTA 967
3. Globe Construction Co., 25 BTA 146.
4. Internal Revenue Code Sec. 23 (e) and (f).
5. Regulations 111, Sec. 29.23 (1)—7.
6. Hazeltine Corp. v. Com'r., 89 F. (2) 513 (CCA 3rd, 1937).
7. Twin Disc Clutch Co., 2 BTA 1327
8. National Piano Mfg. Co., 11 BTA 46
9. Deltax Grass Rug Co., 7 BTA 811; Burke Electric Co., 5 BTA 553.
10. Internal Revenue Code, Sec. 114 (a) and 113 (a) (5).
11. Regulations 111, Sec. 29.23 (1)—6; Hazeltine Corp. v. Com'r., *supra* note 5; O'Neill Mach. Co., 9 BTA 567.
12. A.R.R. 98, 2 C.B. 105; cf Allen & Co., TC Memo Op., Dec. 13, 1916(M).
13. Meyer & Bros. Co., 4 BTA 481.
14. *supra*, Note. 13.
15. Addressograph-Multigraph Corp., *supra*, note 2.
16. Becker Bros. v US, 7 F. (2d) 3 (CCA 2nd, 1925).
17. Peck, Stow & Wilcox Co., 12 BTA 569; Safe Guard Check Writer Corp., 10 BTA 1262.
18. Ward v. US, 32 F. Suup. 743 (1940).
19. Triplex Safety Glass Co. of N. A. v. Latchum, 131 F. (2d) 1023 (CCA 3rd, 1943; W. W. Sly Mfg. Co., 24 BTA 65.
20. Hyatt Roller Bearing Co. v. US, 43 F (2d) 1008 (Ct. of Claims, 1930).
21. Internal Revenue Code, Sec. 117 (a).
22. Myers 6 T. C. No. 32; Diescher, 36 BTA 832; GMC 21507, 1939-2 CB 189; I. T. 3310, 1939-2 CB 190; Bureau Letter Jan. 6, 1944.
23. Internal Revenue Code, Sec. 44.
24. I. T. 3773, Int. Rev. Bull. No. 24 (Dec. 1945).
25. Internal Revenue Code, Sec. 117.
26. Regulations 111, Sec. 29.23 (e)-3.
27. Mertens, "Law of Federal Income Taxations," Sec. 28.19
28. Regulations 111, Sec. 29.23 (e)-3.
29. Liberty Baking Co. v. Heiner, 37 F. (2d) 703 (CCA 3rd, 1930).
30. Connecticut National Pavements, Inc., 3 BTA 1124.
31. *supra*, note 29.
32. See discussion Mertens, *supra*, note 26, Sec. 28.17; CCH Standard Federal Tax Reporter, Par. 197.01.
33. Consolidated Window Glass Co., 1 BTA 365.
34. Regulations 111, Sec. 29.23 (e)-3.
35. *supra*, note 31.

Radar--Military Weapon or Civilian Life Saver?

(Continued from page 7)

A radar installation used for airport traffic control must present the equivalent of a three-dimensional picture of the airport and its surroundings. This will obviously require at least two radar plots, one of which could be a PPI and the other a plot of height versus range for the planes in some given direction. The Teleran system mentioned above reduces the problem to a two-dimensional plot of the PPI type, but provides a separate plot for each altitude zone.

Commercial Radar

Peacetime radar sets will obviously be built to different specifications from those of military radar. In both cases reliability is certainly of prime importance, but cost, which is of negligible importance to the military, becomes vastly more significant in peace. Furthermore, if peacetime radar is to be widely used, the sets must be designed so that operation does not require a highly skilled technician, or frequent maintenance.

If radar is to be used at all it might justify itself economically. Equipment can be designed and built for the applications discussed above, and these should

prove numerous enough and important enough to warrant the expense involved. For example, consider radar for ship navigation. A commercial version has already been demonstrated. Its use is justified for any ship where navigation in crowded waters is necessary, provided the value of the cargo is such as to put a premium on prompt delivery. With radar, collisions can be avoided and the ship go through on schedule, in spite of adverse conditions. One application already suggested is for shipping on the Great Lakes. It might be thought that tugboats and ferry boats in a harbor such as New York would be a fruitful market for radar. However, it is doubtful if the expense is warranted in these cases. On the other hand, overseas shipping, particularly express liners or freighters, could well use radar to advantage in navigating up the harbor.

Consider Loran designed for shipboard use. This is important as an adjunct to the conventional methods of navigation. It should not be considered as replacing them entirely, for the obvious reason that a failure of the electronic equipment would leave the ship completely blind. Shipping using the equipment would then consist of express liners and freighters, travelling in northern waters, for example, where storms and fog make celestial navigation difficult.

(Continued on page 12)