

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-117258-02/CC:PSI:B7

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

University =
Invention =
Date =
State =
x =
y =
z =
Manufacturer =
a =
b =
c =

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ISSUE(S):

Whether Taxpayer is entitled to capital gains treatment under §1235 of the Internal Revenue Code for royalties received from University.

CONCLUSION:

Taxpayer is entitled to capital gains treatment under §1235 for royalties received from University, which are in exchange for all substantial rights in the patent to Invention.

FACTS:

Taxpayer has been a professor at University since Date. University is part of the State University System. Taxpayer's responsibilities have involved teaching, conducting research, and administrative tasks in varying degrees, with between fifty and one hundred percent of Taxpayer's efforts devoted to research during any given academic term. Taxpayer receives a salary for Taxpayer's employment with University.

The collective bargaining agreement, to which Taxpayer is a party, incorporates State's Administrative Code provisions relating to inventions by University employees. The State Administrative Code provides, in part, that an invention which is made in the field or discipline in which the employee is employed by University, or by using University support, is the property of University and the employee shall share in the proceeds therefrom. It further directs the University Vice President to conduct an investigation which assesses the respective equities of the inventor and University in the invention, and determines its importance and the extent to which University should be involved in its protection, development and promotion. The Vice President will then inform the inventor of University's decision on whether or not to assert rights in the invention. If University wishes to own the invention, the division, between University and the inventor, of proceeds generated by the licensing or assignment of patent rights or trade secrets, will be set out in a written contract between University and the inventor. If University decides to not exercise its rights, the invention becomes the sole property of the employee.

In the course of Taxpayer's research, Taxpayer developed Invention. Taxpayer filed patent applications for Invention. Taxpayer then executed assignment agreements which assigned Taxpayer's interest in the patent applications to University. Taxpayer also entered into a royalty distribution agreement with University regarding Invention. The royalty agreement provided that Taxpayer would receive \underline{x} percent of the first $\underline{\$y}$ in royalties resulting from University's licensing of the patents, and \underline{z} percent of royalties in excess of $\underline{\$y}$. University licensed the patents to Manufacturer, who has produced Invention for sale. Taxpayer's share of the royalties paid by Manufacturer for the years in question amounts to $\underline{\$a}$, $\underline{\$b}$ and $\underline{\$c}$, respectively. University has treated these amounts as royalty payments, and not as part of Taxpayer's salary.

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LAW AND ANALYSIS:

Section 1235(a) provides that a transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year, regardless of whether or not payments in consideration of such transfer are -- (1) payable periodically over a period generally coterminous with the transferee's use of the patent, or (2) contingent on the productivity, use, or disposition of the property transferred.

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) related to such creator (within the meaning of §1235(d)).

Section 1.1235-1(c)(2) of the Income Tax Regulations provides that payments received by an employee as compensation for services rendered as an employee under an employment contract requiring the employee to transfer to the employer the rights to any invention by such employee are not attributable to a transfer to which §1235 applies. However, whether payments received by an employee from his employer (under an employment contract or otherwise) are attributable to the transfer by the employee of all substantial rights to a patent (or an undivided interest therein) or are compensation for services rendered the employer by the employee is a question of fact. In determining which is the case, consideration shall be given not only to all the facts and circumstances of the employment relationship but also to whether the amount of such payments depends upon the production, sale, or use by, or the value to, the employer of the patent rights transferred by the employee. If it is determined that payments are attributable to the transfer of patent rights, and all other requirements under §1235 are met, such payments shall be treated as proceeds derived from the sale of a patent.

Section 1.1235-2(a) states that the term "patent" means a patent granted under the provisions of Title 35 of the United States Code, or any foreign patent granting rights generally similar to those under a United States patent. It is not necessary that the patent or patent application for the invention be in existence if the requirements of §1235 are otherwise met.

Initially, it appears that Taxpayer is entitled to §1235 treatment. Section 1235(a) allows long term capital gains treatment for payments received for the transfer, by a holder, of all substantial rights to a patent. It is undisputed that Taxpayer qualifies as a holder under §1235(b), as it was Taxpayer's efforts that created Invention. However, because Invention arose from Taxpayer's employment with University, the requirements of

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§1.1235-1(c)(2) must be satisfied. All of the facts and circumstances of the employment relationship must be considered to determine whether payments to Taxpayer were compensation for services or payment for the transfer of Taxpayer's patent rights. Also, whether the amount of payments depends on the production, sale, use or value of the patent must be considered.

In *Chilton v. Commissioner*, 40 T.C. 552 (1963), the taxpayer was employed as an engineer, responsible for the design of aircraft engines. His employment contract stated that, if the taxpayer invented anything related to aircraft engines or accessories, "all said inventions and improvements shall belong to and be the sole and exclusive property of [employer] in and for all countries of the world." *Id.* at 556. The taxpayer invented several things, many of which his employer selected to have assigned to it. *Id.* at 556-557. The taxpayer patented these inventions, assigned them to his employer, and received various additional payments. *Id.* His employer treated these additional amounts as royalties, rather than including them in with the taxpayer's regular salary. *Id.* at 563. The Tax Court rejected the Commissioner's argument that, because of the quoted language in the taxpayer's employment contract, the taxpayer never owned any substantial rights to transfer. *Id.* at 561. Further, the taxpayer was not "hired to invent," because he was hired to apply his inventive ability, rather than to invent a specific product, and was therefore permitted to treat the royalty payments as long term capital gains under §1235. *Id.* at 563.

In *McClain v. Commissioner*, 40 T.C. 841 (1963), the taxpayer also was employed as a design engineer for an aircraft company. The taxpayer's employment contract contained similar language as in *Chilton* about inventions. The Tax Court found no substantial difference between *McClain* and *Chilton*, stating that the taxpayer had an even better claim under §1235, because the taxpayer in *Chilton* had been hired to improve engine designs and develop new ones. In contrast, the Tax Court rejected the taxpayer's §1235 argument in *Beausoleil v. Commissioner*, 66 T.C. 244 (1976). *Beausoleil* involved an invention incentive program, in which employee inventions earned points toward reward plateaus. The Tax Court found that there was no connection between the eventual achievement award money and the assignments of the rights to individual inventions. *Id.* at 249. Further, the employer treated these awards as salary. *Id.* The payments also bore no relation to the usefulness of the invention. *Id.* at 250. The payments were given ordinary income treatment. *Id.* The U.S. Court of Appeals for the Second Circuit, in applying these cases, also stressed that an important factor to consider in receiving §1235 treatment is whether the payments would continue beyond the employment relationship, for the entire life of the patent. See *Lehman v. Commissioner*, 835 F.2d 431, 436 (2d Cir. 1987).

The facts of Taxpayer's case are essentially equivalent to the facts of *Chilton* and *McClain*. Looking to the facts and circumstances of the employment relationship, the payments in question are connected to the transfer of the rights to Invention, rather

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than compensation for services. The compensation received for the rights to Invention are in addition to and separate from Taxpayer's salary, pursuant to a separate agreement with University. Taxpayer executed a separate assignment of rights document as well. University treats the payments as royalties, and not as salary. It appears that the right to continued receipt of these payments is not contingent on continued employment with University. The amount of the payments received by Taxpayer are dependent on the use or value of the licensing of the patent. The royalty agreement provides that the amount of the payment is a percentage of what University receives in royalties from its licensing of the patent. The amount received varied substantially during the years in question.

There is a question of whether the provisions of the State Administrative Code pertaining to research at University preclude Taxpayer from ever having acquired any interest in Invention. If this were so, §1235 treatment would be precluded, because Taxpayer would have no rights to transfer. The well established principle is that initial patent rights vest with the inventor. See 35 U.S.C. §111; *Beech Aircraft Corp. v. EDO Corp.*, 990 F.2d 1237, 1248 (Fed. Cir. 1993); *Teets v. Chromalloy Gas Turbine Corp.*, 83 F.3d 403, 407 (Fed. Cir. 1996) (“...an invention presumptively belongs to its creator”). “The federal Patent Act leaves no room for states to supplement the national standard for inventorship.” See *University of Colorado Foundation, Inc. v. American Cyanamid Co.*, 196 F.3d 1366, 1372 (Fed. Cir. 1999). “Therefore, the field of federal patent law preempts any state law that purports to define rights based on inventorship.” *Id.* State contract and property law may govern with respect to determining who has acquired rights from the inventor, but it cannot supplant the creation of such rights under federal law. There is no dispute that University acquired a property interest in Invention from Taxpayer, but state statutes cannot operate to extinguish inventorship.

The provisions in the State Administrative Code should be read as having the same effect as similar contract provisions in the cases cited above. Any other reading would leave the statute preempted. This reading is consistent with the reading of the Administrative Code itself, which acts as a handbook of University policy. Because University is an organ of State, the policies of University have been codified, along with the policies of all the schools in the State university system. The State Administrative Code has been included in the collective bargaining agreement between University professors and University. The State Administrative Code sections themselves do not appear to attempt to abrogate the inventor's initial property rights. The provisions are contractual in nature, calling for the assignment of rights in order to share in the proceeds. University must exercise its rights if it wishes to take full ownership of a particular invention. In situations in which University decides not to obtain a particular invention, the employee may keep it. This reading is consistent with the submitted opinion of the University Office of General Counsel. Thus, even if state law could extinguish any possible rights an employee may acquire through creation of an invention, this statute does not do that.

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It is of no concern that the transfer of rights to future inventions took place in the adoption of Taxpayer's employment contract. Section 1.1235-2(a) states that the patent need not be in existence at the time of the transfer for §1235 to apply. In an analogous case regarding an independent contractor, the Tax Court explained the relating back concept. See *Gilson v. Commissioner*, T.C. Memo 1984-447 (1984). "... [T]he taxpayer's obligation from the outset to assign his invention to the other party does not render unavailable the benefits of section 1235 - - it is unimportant whether the contract to assign is viewed as executory, so that no 'transfer' occurs until formal assignment and payment, or whether the payment is viewed as relating back to the previous transfer of patent rights." *Id.* It is irrelevant for the purposes of §1235 whether the substantial rights are viewed as having been transferred in the original employment contract, or in the later assignment document.

For the foregoing reasons, we conclude that Taxpayer is entitled to capital gains treatment under §1235 for royalty payments received in exchange for all substantial rights to the patents for Invention.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.