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Ruth E. Riddell

Member, Michigan Bar

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PATENT ROYALTIES AS CAPITAL GAINS UNDER I.R.C.,
SECTION 117(a)

Ruth E. Riddell*

Introduction

With the incidence of high personal surtax rates, a patentee is ordinarily interested in deriving the greatest monetary return after taxes, measured in proportion to the extent of use over what he expects to be the increasingly productive life of the intangible right evidenced by his patent, without surrendering his option to reclaim the patent in event of insolvency or lack of diligence on the part of the person to whom he transfers the patent for exploitation. Although ideal for these purposes, the favorable capital gain status under section 117(a) of the Internal Revenue Code, requiring recognition of only fifty per cent of gains resulting in any one year from the sale or exchange of property held over six months,¹ is not only difficult for such a patent owner to achieve, but expensive to maintain, in view of the Treasury's persistent efforts to have the courts overrule, or at least narrowly limit application of, the Edward C. Myers case,² which is the leading authority relied upon by patentees seeking capital gain rather than ordinary income treatment of proceeds from transfers with price payable in installments measured by the transferee exploiter's production, sale or use under a patent.

During the past decade, patent owners have been restrained on one side by revived interest in antitrust limitations, enforced in both public and private litigation,³ while being nearly blinded on the other side by the "flash of creative genius" criterion of invention enunciated in Cuno Engineering Corporation v. Automatic Devices Corporation,⁴ which added to a growing apprehension finally crystallized in the suggestion of Justice Jackson in his dissenting opinion in Jungerson v. Ostby & Barton Company,⁵ that there is a "strong passion in this [Supreme] Court for striking . . . [patents] down so that the only patent that is valid is one which this Court has not been able to get its hands on."

* Member, Michigan Bar.—Ed.
¹ 26 U.S.C. (1946) §117(a) and (b).
⁴ 314 U.S. 84 at 91, 62 S.Ct. 37 (1941).
⁵ 335 U.S. 560 at 572, 60 S.Ct. 269 (1949).
In what, therefore, was considered to be a somewhat precarious economic position for patentees, the Commissioner's withdrawal of acquiescence and substitution of a nonacquiescence in the Myers decision on March 20, 1950, cast further doubt upon the ultimate value of a patent grant. Add to this the Treasury's direct attempt in 1950 to have Congress exclude from the definition of capital assets a patent held by its inventor, as was done relative to copyrights and their creators, and the 1951 attempt to accomplish the same result by the indirect method of lumping dividends, interest and broadly defined patent royalties into one class for a proposed new flat twenty per cent withholding by corporations making such payments to individuals, and the possibility of further diminution in the net value of patents becomes more imminent as the Treasury continues its efforts to preserve the revenues.

Patent Legislation

In carrying out the constitutional mandate to promote the progress of science and useful arts by securing for limited times to inventors the exclusive right to their respective discoveries, Congress has provided that a patent grants to the patentee and his assigns, for the term of seventeen years, "the exclusive right to make, use, and vend the invention or discovery ... throughout the United States and the Territories thereof." This statute is implemented by specific provisions relative to patent assignments, reading in part,

"Every application for patent or patent or any interest therein shall be assignable in law by an instrument in writing, and the applicant or patentee or his assigns ... may in like manner grant and convey an exclusive right under his application for patent or patent to the whole or any specified part of the United States."

Income Tax Legislation

When a patentee derives income in the United States upon the transfer of his patent, the basic issue is whether he receives royalties for the rental of his patent or capital gain upon its sale.

6 1950-1 Cum. Bul. 9, Mm. 6490; quoted on p. 1007 below.
7 See pp. 1008-1010 below.
8 See pp. 1010-1012 below.
9 U.S. Const., Art I, §8, cl. 8.
11 Id., §47.
Gross income is defined as including: "... rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas ... and other like property."\(^{12}\)

Only to the extent provided by specific exclusion, deduction or other favorable statutory treatment, does any income escape ordinary tax and surtax. The passage of what is now section 117 of the Code, granting favorable treatment to the realization of gains on the sale or exchange of capital assets, was prompted by an economic policy succinctly explained in *Commissioner v. Hopkinson*,\(^{13}\) thus:

"Congress was aware when it enacted the net capital gains provisions that high surtaxes were preventing the sale or exchange of property because gains and profits which were in fact the result of enhancement in value over a number of years were all treated as taxable income for the year in which the gains or profits were realized by sale or exchange."

For present purposes, it is well to keep in mind the pre-1950 definition of capital assets subject to capital gain treatment, which was:

"The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l). . . ."\(^{14}\)

Section 23(l) of the Code provides for deducting, in computations of net income, a reasonable allowance for exhaustion, wear, tear and obsolescence of property used in the trade or business or of property held for the production of income.\(^{15}\)

It is well settled that a patent used in a business is a form of property subject to the allowance for depreciation, which, generally, must be spread over the seventeen-year life of the patent.\(^{16}\)

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\(^{13}\) (2d Cir. 1942) 126 F. (2d) 406 at 410.


\(^{15}\) Id., §23(1).

\(^{16}\) Hazeltine Corp. v. Commissioner, (3d Cir. 1937) 89 F. (2d) 513.
Interpretative Cases

Of the three cases most commonly used as guideposts in this field, Waterman v. Mackenzie,\textsuperscript{17} Parke, Davis and Company,\textsuperscript{18} and Edward C. Myers,\textsuperscript{19} only the last involved a determination under the capital gains provisions of the Code. The body of interpretative law was developed step by step as new facets of the problem appeared between 1934, when the Parke Davis case was decided, and 1950, when the Commissioner indicated his nonacquiescence in the Myers decision. Accordingly, the principles established by decisions announced during this sixteen-year period will be discussed generally, with emphasis on the three leading cases in their chronological order. Consideration of the nonacquiescence and statutory proposals which have followed in its wake will precede a discussion of decisions announced since the nonacquiescence.

Waterman v. Mackenzie

In 1886, penman Waterman sued Mackenzie and others for infringing a patent on an improvement in fountain pens. The complaint was dismissed upon a holding that Waterman could not sue in his own name to protect his interest in the patent, and the dismissal was affirmed in the Supreme Court.

Waterman, as original patentee, had assigned the patent outright to his wife. Following this, Waterman and wife signed a "license agreement" whereby the wife granted him an "exclusive right to manufacture and sell fountain penholders containing the said patented improvement" in return for a license fee of twenty-five cents upon each penholder manufactured by him. Five days later, Waterman and wife assigned the patent to a third person as security for a loan, subject to Waterman's license "to manufacture and sell pens." Later, the wife executed an assignment to Waterman of her then interest in the patent, and Waterman sued for infringement.

In deciding that Waterman held a mere license from his wife under their original "license agreement" and that they had assigned the legal title to a third person for security, subject only to Waterman's license, in the interim between their license agreement and the wife's purported reassignment of the patent to Waterman, the Supreme Court stated:

\textsuperscript{17} 138 U.S. 252, 11 S.Ct. 334 (1891).
\textsuperscript{18} 31 B.T.A. 427 (1934).
\textsuperscript{19} 6 T.C. 258, 68 U.S.P.Q. 346 (1946).
‘... the ‘license agreement’ between them . . . granted to him ‘the sole and exclusive right and license to manufacture and sell fountain penholders containing the said patented improvement throughout the United States.’ This did not include the right to use such penholders, at least if manufactured by third persons, and was therefore a mere license, and not an assignment of any title, and did not give the licensee the right to sue alone, at law or in equity, for an infringement of the patent.’

The opening paragraphs of the opinion contain what has become accepted as the classical exposition of the principles by which assignments and licenses are distinguished for tax purposes, viz.:

‘... The patentee or his assigns may, by instrument in writing, assign, grant and convey, either, 1st, the whole patent, comprising the exclusive right to make, use and vend the invention throughout the United States; or, 2d, an undivided part or share of that exclusive right; or, 3rd, the exclusive right under the patent within and throughout a specified part of the United States. Rev. Stat. §4898. A transfer of either of these three kinds of interests is an assignment, properly speaking, and vests in the assignee a title in so much of the patent itself, with a right to sue infringers; in the second case, jointly with the assignor; in the first and third cases, in the name of the assignee alone. Any assignment or transfer, short of one of these, is a mere license, giving the licensee no title in the patent, and no right to sue at law in his own name for an infringement. Rev. Stat. 4919; ... In equity, as at law, when the transfer amounts to a license only, the title remains in the owner of the patent; and suit must be brought in his name, and never in the name of the licensee alone. . . .

‘Whether a transfer of a particular right or interest under a patent is an assignment or a license does not depend upon the name by which it calls itself, but upon the legal effect of its provisions.’

This case was limited to the narrow issue of whether or not, under strict rules of old common law pleading, a person who received a transfer under a penholder patent, without mention of legal title or the insignificant right to use such a penholder, while being granted the ‘exclusive right to manufacture and sell,’ could sue in his own name to protect his interest against third persons who were infringing the patent.

Few cases involving capital gain provisions in relation to patent transfers are decided without citing this Waterman case either for or

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against taxability. Thus, from the rigidities of a common law pleading decision, there has been imported into the extremely practical tax field the principle that a taxpayer who grants to another less than the full right to make, use and vend under his patent, except where limited only by geographic bounds or by a specific percentage of the whole three rights, has not assigned property, but only licensed its use, and, therefore cannot claim that such transfer constitutes the transfer of a capital asset. Even if we accept the general proposition, the italicized exceptions do not seem logically distinguishable therefrom in determining capital asset transfer, particularly in that a one-third slice of the three patent rights cut horizontally carries title, while a one-third slice cut vertically is a mere license. 21

The Parke, Davis & Company Case22

One of the earliest determinations of whether a transaction was an assignment or a license for tax purposes was made in this 1934 case. The taxpayer and a competing pharmaceutical manufacturer, Eli Lilly & Co., who together controlled the capsule medicine field, desired to acquire a recently perfected patent on machinery for making and filing capsules, previously done by hand work. Taxpayer purchased from the inventor an outright assignment of the patent, some applications and some machinery manufactured in accordance therewith. The inventor agreed to disclose future improvements and not to sell similar machinery to anyone else. The price was $1,430,000, of which $1,224,257 was allocated to the patent rights. Contemporaneously, the taxpayer and the Lilly Company executed a "license" agreement, whereby, for a sum equal to one-half of the cost which the taxpayer allocated to the patent rights, taxpayer, as "licensor," agreed to "sell and grant" to the Lilly Company, as "licensee," the "exclusive right . . . to manufacture and have manufactured for its exclusive use, and to use but not to sell," the inventions during the life of the patent or any improvements thereof. Each party agreed not to sell or license its respective patent rights or to sell or lease the patented machinery without the other's consent. The taxpayer alone was to bring infringement suits, but each party was to share equally in the expense and proceeds thereof. Lilly paid the entire

21 A propos of this, see the dissent in Commissioner v. Wodehouse, 337 U.S. 369 at 404, 69 S.Ct. 1120 (1949), criticizing the "notion of the indivisibility of copyrights" in determining taxability of transfer of a nonresident alien of one right under a copyright.

22 31 B.T.A. 427 (1934).
consideration to the taxpayer during the taxable year. The taxpayer treated such payment of one-half of its cost as a return of capital, using the remaining half as its base for amortizing cost of its retained rights.

Relying upon the Waterman case, the Commissioner contended that the payment received from the Lilly Company was not a tax-free capital return, but taxable ordinary income received upon a license to use the patent because only the right to make and use, without the right to sell, was transferred by taxpayer to Lilly, and taxpayer alone could sue for infringement.

The Board decided that there had been a transfer of a one-half interest in the patent, thus making the consideration a return on transferred capital and not income. The Board followed unquestioned precedent in holding of no consequence the fact that the agreement designated the parties as "licensor" and "licensee." However, referring to cases like Waterman v. Mackenzie, which hold that a transferee acquiring less than all three statutory rights, to make, use and sell, does not obtain legal title to the patent, and hence, could not sue for infringement, the Board stated that the right to maintain a suit at law is limited to the holder of "the naked legal title," and that, "here we have a question of income tax liability where legal title is of little consequence and the inquiry is as to the ownership of the beneficial interest."23 The Board held that the provision that infringement suits must be brought by the taxpayer was not controlling because the requirement that costs and proceeds should be divided would make the taxpayer only a nominal plaintiff for the benefit of both in event of an infringement suit.

The Board's reasoning follows a somewhat devious course. After stating that they were not controlled by the Waterman technicalities as to title transfer, but were seeking "ownership of the beneficial interest," they took great pains to squeeze the knotty Parke Davis agreement into the framework of the second category established by Waterman, namely, "an undivided part or share of that exclusive right." In doing so, the main feature relied upon by the Board to surmount the hurdle of taxpayer's failure to grant to Lilly the right to sell the inventions was the cross restrictive covenants by which each party bound itself not to sell or license its patent rights, nor sell or lease machines manufactured in accordance with their teachings, without the consent of the other party.

23 Id. at 431.
It appears that the Parke Davis case actually tried to follow the Waterman formula, while deciding that the transfer of something less than an undivided part of all three statutory patent rights, to make, use and vend, was an assignment. Such an observation is particularly appropriate at this time because of the prevalence of antitrust controversies,24 one of the results of which has been the judicial cancellation of the Parke Davis-Lilly contract involved in this tax case. It is paradoxical, but the cross restrictive covenants, which defeated the Government's right to tax a half million dollar transaction involved in this 1934 tax case, were specified as part of the restraint of trade conspiracy between Parke Davis, Lilly and their transferor, Patentee Colton, of which the Government complained in an antitrust complaint against Parke Davis and Lilly in 1950, for misuse of patent rights in monopolizing the capsule making trade, which culminated in a consent decree entered September 6, 1951, cancelling this contract between Parke Davis and Lilly, and ordering them to grant a non-exclusive royalty-free license under their capsule machinery patents to any third person who applied therefor in writing.25

If these cross restrictive covenants had received this same judicial treatment at the time the Board decided the tax case, a different tax consequence would have been indicated even under the Board's reasoning because the transferee now has a non-exclusive license.

The history of this agreement points up a warning that any patent agreement which is claimed to be an assignment for tax purposes because it contains restrictions upon the right to make, use or vend, may be caught in the current hue and cry against restraints of trade.

Parke Davis to Myers Nonacquiescence

A. The Myers Case.26 By the year 1950, the various principles governing taxability of most types of patent transfers that American ingenuity could conceive, hammered out by alternate blows of taxpayers and the Treasury as they passed through the heat of litigation, had reached fairly definite form. Although agreements might, and usually did, contain some hybrid characteristics, the main line of demarcation generally recognized, as in the Myers case, was that payments under an

24 See Introduction above.
assignment of a patent which was a capital asset constituted purchase price for sale of a capital asset, while payments under a patent license constituted royalty for rental of a patent right.\textsuperscript{27}

This 1946 Myers case is regarded as a landmark more because of the number than because of the newness of issues involved. The Tax Court held that quarterly payments totalling $78,000, received during 1941 by taxpayer Myers from the B. F. Goodrich Company under a 1932 agreement as supplemented in 1940, represented long-term capital gains because they were installment payments on sale price of an invention and improvements on a rubber covered flexible steel track, which taxpayer had conceived in 1927 and completed in 1929, with patent applied for in 1932, sixteen days after his initial agreement with the Goodrich Company. The patent was not issued until 1935. In rejecting the Government's contentions that these payments were ordinary income as royalties paid upon a license covering property which was not a capital asset as defined in the capital gain statute and which taxpayer had held for less than the then required twenty-four month period for long-term capital gains, the court enunciated the following principles:

(1) An exclusive license to make, use and sell throughout the United States, with right in the licensee to sublicense others, constitutes an assignment of an invention and subsequently issued patent, even though subject to (a) the licensor's right to terminate exclusiveness on failure of the licensee to pay minimum royalty and (b) the licensee's right to terminate by sixty days' notice. These two termination rights were held to be conditions subsequent, upon occurrence of either of which title could revert, but neither of which militated against the initial passage of title to the transferee.\textsuperscript{28}

(2) That the agreement was designated as a “license,” and the parties as “licensor” and “licensee,” and contained provision for the

\textsuperscript{27}Ibid.; Commissioner v. Celanese Corp., (D.C. Cir. 1944) 140 F. (2d) 339; Kimble Glass Co., 9 T.C. 183, 74 U.S.P.Q. 319 (1947). Cf. General Aniline & Film Corp. v. Commissioner, (2d Cir. 1944) 139 F. (2d) 759 at 760: “We incline strongly to the belief that title to the patents passed to petitioner, . . . However, the passing of title does not preclude the existence of royalties.” See limitation of the Aniline case in Rohmer v. Commissioner, (2d Cir. 1946) 153 F. (2d) 61, cert. den. 328 U.S. 862, 66 S.Ct. 1367 (1946). See also: Misbourne Pictures, Ltd. v. Johnson, (2d Cir. 1951) 189 F. (2d) 774 at 776: “Perhaps not all of the decisions respecting a transfer of less than all the rights in property of a limited life, such as patents, copyrights or literary property can be consistently reconciled [Citing cases].”

\textsuperscript{28}To the same effect, see Lester P. Barlow, 2 T.C.M. 133 (1943); Commissioner v. Celanese Corp., (D.C. Cir. 1944) 140 F. (2d) 339, 61 U.S.P.Q. 14; Raymond M. Hessert, 6 T.C.M. 1190 (1947); Kimble Glass Co., 9 T.C. 183, 74 U.S.P.Q. 319 (1947); Carl G. Dreymann, 11 T.C.M. 153, 78 U.S.P.Q. 302 (1948) 9 T.C.M. 132 (1950).
payment of "royalties," was not determinative of whether in legal contemplation it was a license or a sale, or whether the payments were royalties or installments of purchase price. 29

(3) When a capital asset such as an invention or patent is assigned and not merely licensed, payments to the assignor by a fixed percentage of the assignee's sales price on devices manufactured in accordance therewith during the life of the patent are installment payments on the purchase price and not royalties for rental of a patent right. 30

(4) An invention and the patent thereon can be assigned by an instrument executed prior to the time the patent is applied for and still constitute an assignment of "property" subject to capital gain treatment.

(5) In computing length of time that a patentee has held his invention, his holding period dates from the time that he completes his conception and design so that others can construct a device therefrom without further exercise of the inventive faculty.

(6) A patentee who is employed by others at a salary and who conceives and transfers his one and only invention, does not thereby transfer property held by him "primarily for sale to customers in the ordinary course of his trade or business," within the meaning of the statutory exception from capital asset definition.

B. Capital Assets or Property Held Primarily for Sale. This latter point is one of the most frequent upon which the Treasury attacks patent transfers, contending that a patent in issue has been "held by the taxpayer primarily for sale to customers in the ordinary course of his business," within the phrase now appearing in section 117(a) of the Code in defining property not to be considered as "capital assets." In determining whether or not a patent is within the excluded class, courts hold that if the income-producing factor in connection with the invention is a somewhat casual, unusual or isolated affair, particularly where


30 The following were also held capital gains: Commissioner v. Hopkinson, (2d Cir. 1942) 126 F. (2d) 406 (a fixed sum per unit manufactured); Lester P. Barlow, 2 T.C.M. 133 (1943) (percentage of royalties received under "sub-license"); Carl G. Dreymann, 11 T.C. 155, 78 U.S.P.Q. 302 (1948) 9 T.C.M. 132 (1950) (percentage of gross sales); Raymond M. Hessert, 6 T.C.M. 1190 (1947), and Eldred Slug Casting Machine Co., 7 T.C.M. 157 (1948) (percentage of sales until aggregate reaches a fixed sum).
the development has been in the nature of a hobby or recreation, or where the sale is outside the normal phase of the taxpayer's business activities, the patent will be classified as a capital asset.

The following cases, listed in chronological order, held patents were capital assets, viz:

In *Samuel E. Diescher* a partnership had owned four patents, five inventions upon which applications for patents had been filed, nine inventions on which no applications had been filed, and two foreign patents and thirteen foreign patent applications. Two licenses to use the United States patents had been granted in exchange for royalty payments. The firm was engaged in the business of furnishing consulting engineering service, the invention of processes and devices, and the patenting and licensing thereof. In the tax year, the partnership conveyed its patents and inventions to a corporation organized for that purpose. On the issue whether the gain realized was capital gain or ordinary income, the court rejected the Commissioner's contention that the patents had been held primarily for sale in the course of the partnership business, stating that there was nothing indicating that the partnership had ever been in the business of buying and selling patents, or in developing inventions for sale, but that in all other patent transactions the firm had merely licensed their use, pointing particularly to the fact that the basic patent transferred, which represented the largest individual value of all the transferred patents, had been owned by the partnership for many years and its use by others had always been upon license. Unfortunately, this narrow distinction in such extensive patent dealings was not in issue upon the appeal.

In *Lester P. Barlow* the taxpayer was a mechanical engineer, who, the court found, "has been engaged since 1910 exclusively in the business of inventing, developing and exploiting inventions for profit." He had licensed all his inventions but two, which he sold. In 1917, he sold and assigned an invention on an aircraft drop bomb to an arms manufacturer for cash and a percentage of net profits on manufactured bombs, later changed to a division of royalties to be paid by the United States Army. Taxpayer had the right of cancellation if his payments fell below $50,000 in any year. He received some payments, but, by 1923, there

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32 2 T.C.M. 133 (1943).
was $200,000 due and unpaid. The arms manufacturer went into receivership, and, in settlement of the parties' rights under the 1917 contract, the receiver assigned to taxpayer all rights in his patent, including the right to royalties due from the Army. Taxpayer sued the United States in the Court of Claims, and, in 1940, recovered these royalties. In reviewing his 1940 tax return, the Tax Court held that his inventions were not stock in trade because, although he was in the business of inventing, he ordinarily licensed his inventions and was not generally in the business of selling inventions or patents; that the payment received from the United States was not payment of a claim against the United States which would be taxable as ordinary income, but the realization of gain upon his 1917 sale of the invention to the arms manufacturer, and that, as such, it was gain upon sale of a capital asset. Inter alia, the court also ruled, in determining that his 1917 sale was a long-term sale of an asset held more than eighteen months, that his holding period dated from his reduction of the device to practice in 1914.

Again, the fine distinction drawn in the meaning of patents "held primarily for sale . . . in the ordinary course of his business," was not reviewed by an appeal court. Perhaps the Tax Court felt such legal hair-splitting justified in deciding for a taxpayer who had waited from World War I to the beginning of World War II before he was paid by the Government for an invention which was of great assistance to this country, during which time surtaxes had steadily mounted.

In John W. Hogg, the taxpayer, a graduate mechanical engineer, in addition to his regular employment as a "trouble shooter" and clerk, spent about four hours a week working on devices which he thought might be patentable, and on which four patents were issued in eighteen years. He was held not to be "an inventor engaged in the development, licensing and sale of patents," as contended by the Commissioner, and the sale of one patent in 1940, after royalties had been paid thereon for four years and reported as ordinary income, was held to constitute sale of a capital asset not held "primarily for sale to customers in the ordinary course of his trade or business."

In 1947, the Court of Appeals for the Ninth Circuit held, in United States v. Adamson, that the transfer of one patent and trademark in connection with the dissolution of a partnership formed to deal

33 3 T.C.M. 212 at 213 (1944).
34 (9th Cir. 1947) 161 F. (2d) 942.
in yarns, and not engaged in the business of selling patents, was without the quoted exception.

In Leo P. Curtin the taxpayer had invented wood preserving and metal coating processes while working for Western Union. He assigned two patents to Western Union, receiving back exclusive licenses outside the field of electrical communications. He formed a corporation to exploit the inventions, to which he assigned his licenses in return for an agreement that he should be paid a percentage of the corporation's gross income. Later, he developed a third metal coating process, and a new agreement was signed whereby his interest in his present and future inventions was transferred to the corporation, which promised to pay him a percentage of gross income and not to assign the patent rights without his consent and without paying him one-half of the profit upon sale. In 1940, the corporation sold its metal coating and rustproofing business and patent rights to Parker Rust Proof Company, and the Commissioner contended that the share of profit thereupon paid to taxpayer was taxable as ordinary income. The court reasoned that, although taxpayer had applied for forty patents, they covered only five or six basic inventions, which had been assigned for exploitation to Curtin-Howe Corporation, headed and largely owned by taxpayer. This situation was deemed to be different from those where patents are sold to several independent purchasers solely to obtain immediate profits. Concluding that Curtin was not in the business of selling patents, he was allowed capital gain treatment for the sale of all his patent interests.

In determining that Curtin had assigned capital assets, no recognition appears of the fact that Curtin's interest in each of the initial patents was a vertical slice cut off each of the three patent rights held by Western Union, namely a license outside the electrical communication field.

This case presents another example of the prevalence of antitrust implications. The 1940 sales agreement between Curtin-Howe and Parker Rust Proof Company was attacked as in restraint of trade in an antitrust suit in the federal court at Detroit.

In William M. Kelly taxpayer had started to work as a compositor for American Type Founders Co. in 1894, and later developed im-
provements on a printing press. He was thereupon assigned to do inventing work, receiving a salary plus various amounts for patent rights to his inventions as they were developed. He stopped working in 1935, and, in 1938 through 1941, received amounts from his former employer for assigning patents and inventions to it. The court held that the taxpayer did not hold the patents primarily for sale to customers in the ordinary course of his own business and that they were not property used in his own trade or business. The court likewise rejected the Commissioner's alternative contention that such payments were additional wages, holding that, under the employment contract, the employer did not consider itself owner of the patents without obtaining specific assignments from the taxpayer. 38

Carl G. Dreymann's experiences present a noteworthy example of the expense of maintaining a capital gain status. In his first contest over taxability of his installment payments under a patent covering moisture proof paper, 39 the court held that his income from transferring this patent to a corporation which had employed him to perfect his independently conceived idea was long-term capital gain and not compensation of an employee, and that he was not in the business of selling patents merely because he had previously sold one patent. Three weeks later, the Tax Court reached what appears to be an opposite result in the Paul L. Kuzmick case, 40 by deciding that because Kuzmick had orally agreed with a corporation which financed development of his independent inventions that he would assign the inventions to it, the corporation "acquired a right to them upon petitioner's [Kuzmick's] perfecting them," and, therefore, he did not have any holding period for computing long-term capital gains. In reviewing the Dreymann returns for two later years, the Treasury contended that the Kuzmick case had overruled the original Dreymann case, and that, accordingly, Dreymann must pay ordinary gain rates upon his returns for later years. In the second case 41 which Dreymann had to institute to maintain his favorable tax status on the same transaction, the court held that the rule of stare decisis applied, and that the Kuzmick case had not overruled the original Dreymann case.

38 See also Raymond M. Hessert, 6 T.C.M. 1190 (1947) holding payments were purchase price and not salary. Contra: Blum v. Commissioner, (3d Cir. 1950) 183 F. (2d) 281; William B. Stout, 18 T.C.M. 851, aff'd. (6th Cir. 1950) 185 F. (2d) 854.
40 11 T.C. 288 at 297 (1948).
41 Carl G. Dreymann, 9 T.C.M. 132 (1950).
The original Dreymann opinion reveals the Treasury's attitude toward all installment payments on patent transfers, namely, that to apply long-term capital gain treatment thereto is "repugnant to the underlying theory of the capital gain limitations" because the purpose of such limitations was to lessen the impact of income tax on the realization in one lump sum in one taxable year of an increment in value which has taken place over a number of years. However, the court stated that section 117 did not provide that payment upon the sale of a capital asset had to be in one lump sum to receive capital gain treatment. The Commissioner indicated his nonacquiescence in the original Dreymann case on August 7, 1950, limited to the point here under discussion.42

Just why, in 1948 and later, the Treasury should contend that to permit the spreading of capital gain tax on patent installment payments over the years of such payments is "repugnant to the underlying theory of the capital gain limitations," is difficult to fathom in view of section 44 of the Code,43 which has permitted such treatment since the 1930's as to almost every general property installment sale by providing for reporting each year only the proportion of the installment payments received which the gross profit bears to the total contract price.

In Hofferbert v. Briggs,44 the Court of Appeals for the Fourth Circuit practically without explanation affirmed a holding of the lower court that where an employee had transferred inventions to his employer, he was entitled to capital gain treatment for royalties paid in addition to salary.

In the following cases, it was decided that patents were not capital assets within the statutory definition, viz:

Harold T. Avery45 is the mainstay of the Treasury on this phase of the treatment of patentees. Practically every opinion in the immediately preceding subdivision has distinguished its holding from that in the Avery case. During a period of about seventeen years, Mr. Avery procured twelve patents on inventions developed outside his regular employment. Certain inventions led to his employment by a manufacturer of calculating machines and the sale to such employer of two inventions for which he had previously filed patent applications. One was sold to

42 1950 INT. REV. BUL. No. 16 at 2.
43 26 U.S.C. (1946) §44.
45 47 B.T.A. 538 (1942).
his employer in 1935 for $30,000, payable in installments over a period of years, proceeds from which were in issue in this tax case. He had also granted certain rights in two other patents, from one of which he had received royalties for ten years at the time of this decision. He had been chief engineer of the calculating machine company since 1929, directing design and experimental work in connection with new developments in which the company was interested, including the invention and improvement of calculating machines. The court stressed particularly that outside of his regular employment he personally was engaged in the business of inventing, procuring, selling and licensing patents, although finding that he was “very active in church and civic organizations and technical societies,” and “the time which he devoted to the development of inventions other than as an employee . . . varied greatly and depended upon the demands of his other activities upon his spare time.” The court concluded that the patent sold to his employer in 1935 was held “primarily for sale to customers in the ordinary course of his trade or business.”

The Leo M. Harvey case held that patents on wire and band tying which were developed in the taxpayer’s sole proprietorship business of making machinery, where he deducted development costs as business expenses, were not the result of a hobby or recreation, but constituted property used in trade or business, so that their sale for $25,000 cash and ten $40,000 annual notes produced ordinary income. The court stated that the development of patents was a normal, logical and natural phase of taxpayer’s business.

The Myers Nonacquiescence

In this state of the law, the Treasury on March 20, 1950, withdrew its 1946 acquiescence to the Myers decision and indicated its nonacquiescence, covering royalties for years beginning June 1, 1950. The nonacquiescence defines clearly the Treasury’s most recent target for its judicial and legislative attack in the area of capital gain treatment of patent proceeds, namely, that all periodic installment payments under patent transfers, generally coterminous with the transferee’s use of the patent, constitutes royalties taxable as ordinary income regardless of whether the transfer is technically an assignment or a license. The pertinent parts read:

46 6 T.C.M. 312 (1947), affd. (9th Cir. 1949) 171 F. (2d) 952. To the same effect, see Paul Smythe, Jr., P-H Memo Dec. No. 42,377 (1942).
47 1950-1 Cum. Bul. 9 Mm. 6490.
2. Further consideration has been given to the question as to whether the decision in the Myers case should be accepted as a precedent in the determination of income tax liabilities of other taxpayers with respect to contracts containing essentially the same provisions.

3. The exclusive license agreement considered in the Myers case provided, among other things, that the licensor is to receive from the licensee, in return for the exclusive right to manufacture, use, and sell the patented article, annual payments equal to 5 percent of the selling price of the articles manufactured and sold, such annual payments, however, not to be less than a specified minimum annual amount.

4. The Bureau has reached the conclusion that where the owner of a patent enters into an agreement whereby, in consideration of the assignment of the patent, or the license of the exclusive right to make, use, and sell a patented article, the assignee or licensee agrees to pay to the assignor or licensor an amount measured by a fixed percentage of the selling price of the article so manufactured and sold, or amounts per unit based upon units manufactured or sold, or any other method measured by production, sale, or use either by assignee or licensee, or amounts payable periodically over a period generally coterminous with the transferee's use of the patent, such agreement, for income tax purposes, is to be regarded as providing for the payment of royalties taxable as ordinary income.

5. Acquiescence in the decision of The Tax Court of the United States in Edward C. Myers v. Commissioner (6 T. C. 258), as it relates to the issue of whether the payments involved therein were taxable as gain from the sale of property, is hereby withdrawn and nonacquiescence substituted.

6. ... this ruling shall not be applied with respect to royalties received from such exclusive license agreements for taxable years beginning prior to June 1, 1950.”

Obviously, operating under these instructions from the Commissioner, Treasury agents must disallow claims for capital gain treatment of any periodic installment income which is coterminous with use of the patent. This attitude is reflected in an upsurge of litigation involving such returns.48

48 E.g., as of December 31, 1951, 20 tax cases were pending on the docket of Chief Judge Lederle of the District Court for the Eastern District of Michigan, of which 4 involved this problem, the first such type cases ever assigned to his docket.
A. 1950 Revenue Act. In June of 1950 the Treasury's proposals for tax amendments for that year appeared in H. R. 8920, which, with changes, became the Revenue Act of 1950. As it passed the House, section 209 of this bill proposed to amend section 117(a) (1) of the Code to read in part as follows:

"(1) CAPITAL Assets—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

"(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), or real property used in his trade or business;

"(C) a patent or copyright; an invention or design; a literary, musical, or artistic composition; or similar property; held by—

"(i) a taxpayer whose personal efforts created such property, or

"(ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property. . . ." (Italics added) 49

This new subdivision (C), in effect, proposed adding to existing exclusions from capital asset definition, patents and copyrights in the hands of their creators and others taking the creators' bases. However, the italicized words, referring to patents, inventions or designs, were deleted before final passage of the act.

In explaining the original proposal, the Report of the House Ways and Means Committee stated:

"When a person is in the profession of inventing, or writing books, or creating other artistic works, his income from the sale of the products of his work is taxed as ordinary income. This is true

whether he receives royalties from the use of his products or sells them outright, since the products of his work are held by him 'primarily for sale to customers in the ordinary course of his trade or business' and are, therefore, not treated as capital assets.

"If an amateur receives royalties on his invention or book or other artistic work, they are treated as ordinary income, but if he holds his invention or book or other artistic work for 6 months and then sells it outright he can avail himself of a loophole which treats such a sale as the sale of a capital asset, not held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business. As a result the taxpayer receives long-term capital gain treatment on the product of his personal effort.

"There is no question under the income tax law that a person may be treated as engaging in more than one trade or business at the same time, and when a person writes a book or creates some other sort of artistic work or devises an invention with the idea of realizing income on it he should be treated as being in the trade or business of writing, creating, or inventing, regardless of whether the income from his personal efforts is realized through royalties or through outright sale, and regardless of the fact that this is the first time he may have engaged in such a trade or business.

"Section 209 (a) of your committee’s bill provides that when any person sells an invention or a book or other artistic work which is the product of his personal effort his income from the sale is taxed as ordinary income. He would, of course, be able to average his income from such work over 36 months, if his activities covered a period of 36 months or more, to the extent permitted by section 107 (b) of the Internal Revenue Code.

"It is estimated that this amendment will yield approximately $1 million annually in additional revenue." (Italics added) 50

Without explanation, the Senate Report on this phase of the proposed act stated blandly, as un fait accompli:

"Section 209 (a) of the House bill would amend section 117 (a) (1) of the code by revising the definition of ‘capital assets’ so as specifically to exclude therefrom patents, copyrights, inventions, designs, literary, musical or artistic compositions, and similar property, in the hands of either (1) the person whose personal efforts created such property or (2) a person deriving a basis for the property, for the purpose of determining gain, from the person who

created it. Your committee has limited the scope of this amendment . . . to copyrights, literary, musical or artistic compositions, and similar property, and has eliminated the proposed change in the treatment of such property as inventions, patents, and designs.” (Italics added)51

The Report of the Conference Committee also reflects this discriminatory classification, and, likewise, does so without a word of explanation for the arbitrary distinction between patents and copyrights, viz.:

“Amendments Nos. 77 and 78: The bill as passed by the House amended section 117 (a) (1) of the Internal Revenue Code so as to exclude copyrights, patents, inventions, designs, and literary, musical, or artistic compositions, and similar property from the definition of ‘capital assets’ when held by certain taxpayers. Amendments Nos. 77 and 78 remove patents, inventions and designs from this exclusion. The House recedes.”52

Prior to this, it was common practice in discussing taxation of patents or copyrights, as it was in discussing general patent and copyright law, to use principles established in patent and copyright cases practically interchangeably, recognizing their almost identical property attributes.53 In fact, Congress itself had recognized their close affinity by classing them together in prior tax legislation.54 However, the Revenue Act of 1950 as finally passed excluded this capital gain limitation which the House had proposed as to patents, but included it as to copyrights, and without any report explaining why Congress made this distinction.

B. 1951 Revenue Act. Congress having refused to adopt the Treasury’s 1950 proposal for a direct statute limiting capital gains on patent transfers, the Treasury in 1951 apparently attempted to accomplish about the same thing through the indirect method of proposing the addition of a new Chapter 6 to the Code, requiring a straight twenty per cent withholding by corporations making payments to indi-

54 26 U.S.C. (1946) §119(a)(4); 26 U.S.C. (1946) §107(b) re spreading tax on
individuals of dividends, interest, and royalties from patents and copyrights. Dividends and interest, of course, have been traditional subjects for ordinary income tax treatment, and, with the 1950 capital gain amendment, copyrights are practically in the same category. Subchapter B covered "royalties," defined in part as:

"(b) any payment, however designated, made by a corporation for the privilege of using any patent, pending application for a patent, copyright, secret process or formula, trade mark, or trade brand, including any payments made by an assignee or an exclusive licensee thereof, if measured by the use of a patent, . . . formula, trade mark, or trade brand, or if payable over a period substantially coterminal with the period of the payor's right to use such property. . . ."

This language bears a striking similarity to the wording of the Myers nonacquiescence, and obviously was designed toward the same end.

The legislative history of the 1951 Revenue Act is replete with discussions of this Chapter 6 proposal, but nowhere is there a hint that this chapter contemplated placing patent royalties, whether received under a license or an assignment, in the same category as interest, dividends and copyright royalties. The following excerpt from the Senate Report is typically uninformative on this point, viz.:

"It has been noted that the House provision would also require withholding with respect to royalty payments. Your committee has not been shown any need for withholding in this area. Royalty payments are much more apt to represent large amounts than is true in the case of dividends and interest and are more apt to be received at regular intervals over a long period of time. For these reasons such payments are more likely to be included in the payee's income. Your committee believes it unlikely that there is any substantial underreporting in this area. It should be pointed out that royalty payments with respect to minerals are frequently subject to depletion and various expense deductions. The House bill makes no allowance for such deductions."

The legislative history indicates that a great wave of opposition income not taxable as capital gain on patents and copyrights resulting from more than 36 months work in inventing or composing.

built up against the interest and dividend withholding, and this swept away the whole proposed Chapter 6, so that, as finally passed, the 1951 Act did not include any of this newly proposed withholding.

C. H. R. 3868. Meanwhile, a proposal appeared in H. R. 3868, introduced by Congressman A. Sidney Camp, of Georgia, on April 26, 1951, which would take a patent held by its inventor out of the "stock in trade" and property held "primarily for sale to customers in the ordinary course of trade or business" exclusions from capital assets. This proposed bill reads:

"That section 117 (a) (1) (A) of the Internal Revenue Code (relating to the definition of capital assets) is amended by inserting before the semicolon at the end thereof the following: 'unless such property is a patent held by a taxpayer who is an individual and whose personal efforts created such property.' Sec. 2. The amendment made by this Act shall be applicable with respect to taxable years beginning after December 31, 1950."

H. R. 3868 was referred to the House Committee on Ways and Means, of which Congressman Camp is a member, on April 26, 1951, which was prior to that Committee's reporting out the 1951 Revenue Act. In answer to an inquiry as to action on H. R. 3868, addressed to Congressman Camp by the writer, he replied by letter dated November 17, 1951, that "this bill has not been considered by the Committee on Ways and Means. I expect to bring it up as soon as possible after the Christmas Holidays."

Under these circumstances, it would appear improper to suggest the inference that, in proposing the 1951 Revenue Bill without including the H. R. 3868 proposal, the Committee intended to reject the proposal.

Recent Cases

Although the Myers nonacquiescence was applicable only to royalties received after June 1, 1950, and then only where amounts were payable periodically over a period generally coterminous with the transferee's use of the patent, it is interesting to note that cases decided since the nonacquiescence was indicated on March 20, 1950, still cite the Myers and other prior cases as authority, and, in fact tend to render rather free translations of their principles, favoring in various ways patentees seeking capital gain treatment.

On February 19, 1951, the Tax Court decided, in *Halsey W. Taylor*, that a 1945 assignment of patents and inventions on water cooling apparatus constituted a sale of capital assets, and payments denominated "royalties" constituted the purchase price in periodic payments, even though the agreement assigned ownership to the patentee taxpayer's family corporation which had previously held a non-exclusive license of the patents under a 1926 agreement, and the 1945 assignment was accompanied by only a nominal cash consideration, the material consideration being the continued payment during taxpayer's lifetime of the same five per cent of net sales as had been paid previously as royalties. The 1945 agreement contained present words of sale and provided that the corporation's obligation to pay royalties terminated at the taxpayer's death.

On April 9, 1951, the Court of Appeals for the Sixth Circuit decided, in *Kavanagh v. Evans*, that a transfer of patent rights was subject to capital gain treatment where the patentee had, in consideration for four annual payments totalling $225,000, granted "a license . . . to manufacture . . . and/or use and/or sell brakes . . . under any and all" of the taxpayer's inventions, improvements and patents, "free from royalty or other license fees," for the life of the patent, the transferee to have the right to grant sub-licenses, subject to the taxpayer's retention of a license "to manufacture for use, and/or sale" brakes under his invention, which right, if not used by taxpayer, could be transferred to one other person. The trial court had interpreted this as an assignment of the patent with a license back to the assignor. In affirming such interpretation, the appellate court gave as a reason: "It was entirely lawful for him (the patentee) to retain an undivided part or share of his exclusive patent rights. [Citing Waterman v. Mackenzie and other cases]." If the conclusion is correct that the agreement constituted an assignment with a license back to the assignor, the license now held by the assignor is not an undivided part or share of the patent rights, but a divided part. As pointed out in *Waterman v. Mackenzie*, an undivided part or share of the patent rights is an assignment as distinguished from a divided part, which is a license.

In *Allen v. Werner*, the Court of Appeals for the Fifth Circuit on July 13, 1951, held subject to capital gain treatment a contract granting an exclusive license to manufacture and sell within the United...
States and Canada an invention covering a hydraulic jack, which sold in a price range from $2.98 to $30.00, where right to use was not specifically reserved in the licensor. The agreement was held to be ambiguous as to whether the taxpayer retained or granted the right of use in the United States, since the agreement acknowledged the licensee’s right of use in Canada while saying nothing about the right of use in the United States. Being ambiguous, the court considered parole evidence showing that the parties had intended a sale of all the licensor’s rights, and decided that the document constituted an assignment rather than a mere license.

Although the court was justified in deciding for taxpayer Werner upon the reasoning just mentioned, it gave as an alternative reason that the grantor’s right to use a jack worth $2.98 to $30.00 would be so inconsequential in value that the court, “seeking the ‘substance of the matter rather than the form,’ in determining the incidence of taxation, should disregard this feature in determining whether the inventor had effected a sale rather than a license.” Such an analysis sounds sensible; but, again, there is nothing in the opinion to disclose that this court realized that such analysis was contrary to the rationale of the putative ancestor of all these cases, Waterman v. MacKenzie,63 which held that failure to grant the right to use a fountain pen made the agreement a license even though the substantial rights, to manufacture and sell under the fountain pen patent, were granted exclusively to the licensee.

In Lamar v. Granger64 a Pennsylvania district court, on July 3, 1951, considered a series of complicated agreements relating to transfer of a valve patent. The court decided that this invention had been conceived by the taxpayer during 1935 while working on a salary as designing engineer for a valve company, and reduced to practice in April, three years later, in the month interval between severance of that employment and his commencing employment as designing engineer for a second valve company. While working at the first company, taxpayer had developed a number of valve improvements, on which patent applications were filed in his employer’s name. The court stated, in a lengthy opinion prefacing its findings of fact and conclusions of law, that these five valve improvements “were developed on company time, with company facilities, and as an incident to his duties as designing engineer,” while finding as a fact that “the valve patent (subject

matter of this tax suit) was developed by taxpayer on his own time and at his own expense." This valve patent was issued on October 15, 1940. The initial contract considered in this case was the December 1939 transfer thereof to a third valve company shortly after it had employed taxpayer immediately following his employment with the second valve company. As against the Government's contentions that the series of agreements constituted licensing divisions of the patent rights, the court construed the contracts as being an initial assignment of the patent with a license back to taxpayer for the joint use thereof in the high pressure and airplane fields. The court found that the taxpayer also had a patent on an "ice-cuber" device developed on the time of the third employer, which was assigned to the latter by taxpayer in exchange for a license back in the high pressure and airplane fields under the valve patent. Income resulting from this latter transaction was held to be ordinary income, while installment payments accruing from the initial transaction constituted long-term capital gain on the sale of a capital asset, owned by the taxpayer, which had not been held by him primarily for sale to customers in the ordinary course of his trade or business, computing his holding period from April 1938, when he had reduced the invention to practice.

These circumstances seem very close to those in the *Avery* case,65 which decided the patent was held primarily for sale. However, no review will be had. The Government filed a notice of appeal on November 17, 1951, but the appeal was dismissed on December 21, 1951, at the request of the Solicitor General.

Another interesting ramification of this assignment vs. license argument developed in *Coffman v. United States*.66 Coffman was the patentee and transferor in the basic agreement involved in the *Federal Laboratories, Inc.* case,67 upon sublicense of which Federal Laboratories sought capital gain treatment. Here, Coffman was suing the Government in the Court of Claims to increase the royalties it had fixed upon such agreement under the Royalty Adjustment Act. The court held that the payments due Coffman from Federal Laboratories were royalties within the meaning of that act, and inferred that this would be true whether the agreement was an assignment or a license. Having in mind that the Government prevailed in its contention in the 1947 *Federal Laboratories* tax case, that the basic agreement was a license

65 47 B.T.A. 538 (1942).
67 8 T.C. 1150 (1947).
and not an assignment, so that Federal Laboratories' interest was not a capital asset to begin with, it is noteworthy that the Government took the opposite position in this Coffman case and moved to dismiss Coffman's petition for an increase of royalties in the Court of Claims on the theory that Coffman had sold and not licensed his patents to Federal Laboratories, and that, therefore, the payments from Federal Laboratories to Coffman were installments on purchase price and not royalties subject to adjustment.

Conclusion

Thus the law stands. The Myers case is still followed by the courts. Treasury agents, following instructions given them in the Myers non-acquiescence, take the opposite position, maintaining that installment payments on either patent assignments or patent licenses are rentals or royalties for the use of or for the privilege of using patents in the United States, taxable as ordinary income. Patentees must litigate in order to maintain their capital gain status. Congress in 1950 refused to pass an amendment in line with the Myers nonacquiescence, and, in the fall of 1951, refused to pass provisions apparently aimed at accomplishing the same result by classing installment payments on patent and copyright transfers in the same category as interest and dividends, traditional ordinary income tax subjects.

Although it is possible to apply the rule of statutory construction that, in refusing to pass specific capital gain limitations as to patents, Congress intended that the law should be otherwise,68 still the situation is one which calls for clarification. It is not aided by the Treasury's failure to seek certiorari in the Supreme Court from the latest decisions approving capital gain treatment of patent assignments.69

It may well be that, if the present Supreme Court should have the opportunity to consider this tax problem, it will re-examine the whole spotty mosaic which forms the background for present holdings, and reconstruct a clear and logical picture of the basis for drawing various distinctions in the law.

Until the Supreme Court speaks or Congress enacts some express provisions, patentees will remain, as the characters in Dickens' Bleak House, "in chancery."

69 However, in Commissioner v. Sunnen, 333 U.S. 591, 68 S.Ct. 715 (1948), the Treasury sought and obtained review on the attempted income-assignment-to-wife phase of a case involving unquestioned non-exclusive licenses.