BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
L. A. JOHNSON)

Appearances:

For Appellant: H. Edwin Nowell, Certified Public Accountant

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; Mark Scholtz, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18593 of the Revenue and Taxation Code (formerly Section 19 of the Personal Income Tax Act) from the action of the Franchise Tax Commissioner on the protest of L. A. Johnson to a proposed assessment of additional personal income tax in the amount of $216.80 for the year 1940.

The proposed assessment is attributable to the Commissioner's disallowance of a deduction from gross income for an asserted loss on the sale of residential property in the amount of $2,875 (Appellant's one-half share of a community loss of $5,750), and the Commissioner's addition to the Appellant's income of the following amounts of gain from the sale of two patents: (1) $2,100 representing the difference between 100% and 30% on a gain of $3,000 from the sale of a patent owned as Appellant's Separate property and held over ten years; (2) $1,800, representing the difference between 100% and 40% on one-half of a community gain of $6,000 from the sale of a patent owned by the Appellant and his wife and held over five years and less than ten years. The issue on the loss from the sale of the residential property has been abandoned by the Appellant, the only matter now requiring decision being the correctness of the Commissioner's action respecting the gain from the sale of the two patents.

For several years prior to 1938 the Appellant was the General Manager of the National Motor Bearing Co., Inc. which for many years engaged in the manufacture of shims, though in the year in question and some years prior thereto it engaged primarily in the manufacture of oil seals. In 1938 he became President of the corporation and held that position in 1940. The Appellant held stock in the corporation, but he was not the sole stockholder and did not at any time own or control a majority of the capital stock. Between 1927 and 1934 he invented and obtained two patents for a certain type of shim. For several years the corporation paid him royalties for the use of these

patents in its manufacturing operations, and in 1940 it purchased them from him. One of the patents, the separate property of the Appellant, had been held by him for over *ten* years and was sold to the corporation for $3,000. The other patent, the community property of the Appellant and his wife, had been held by them for over five years and less than ten years and was sold for $6,000. Each of the patents had a basis of zero. The Appellant was employed by the corporation for the performance of services relating to the management of its operations, not for the development *of* inventions. Except for the patents involved in this proceeding, the Appellant has received no income from any source in connection with any other device invented by him.

In filing his return for 1940 the Appellant listed the gains from the sale of the patents as gains from the sale of capital assets, taken into account at the appropriate percentages. The Commissioner proposed an additional assessment based in part on the treatment of those gains as ordinary income, taken into account at 100%.

The term "capital assets" is defined in Section 9.4(b) of the Personal Income Tax Act, as amended in 1939, as follows:

> "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 invantorg 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 8 (i)."

The question presented herein is whether the patents sold in 1940 were held by the Appellant primarily for sale to customers in the ordinary course of business within the meaning of this provision. The Appellant contends that under the facts here he was not engaged in the trade or business of inventing and selling patents and, accordingly, that the incidental sale of a patent results in a capital gain. The Commissioner, in his contention to the contrary, relies heavily upon Harold T. Avery, 47 B.T.A. 538. In that case the taxpayer, during a period of seventeen years, had procured about twelve patents on inventions developed outside his regular hours of employment. Certain of these inventions led to his employment by a calculating machine corporation, his duties being to invent and improve calculating and similar type machines and to direct the design and experimental work of the corporation. He sold two inventions, which pre-dated his employment, to his employer. He also sold another patent in another field to another company and licensed two other patents to others than his employer for which he received royalties. The taxpayer's inventing began as a hobby, but the court concluded that the activity that originally might have been a hobby had developed into a business enterprise. It held, therefore, that

the first patent sold to the calculating machine corporation, from which tho income there involved was derived, was property held by him primarily for sale to customers in the ordinary course of business.

The Tax Court, distinguishing the Avery case, has held that in the case of an individual who was a "trouble shooter" or clerk, working on inventions in his spare time as a hobby and patenting Pour inventions, one of which was sold to a third party during the taxable year, his activities in connection with the patents had not reached the proportions of a trade or business and the sale of the patent constituted the sale of a capital asset. John W. Hogg, T. C. Memo. Op. , Dkt. 112504 (March 1, 1944). The Tax Court, again distinguishing the Avery case, has also held that in the case of an individual who made inventions as incidents to and part of his regular employment as a chemical and industrial engineer, his employment contracts providing that his inventions were to be -the property of his employers if they desired to have them, a sale of a patent, in which his employer had ceased to be interested, to a third party did not constitute the sale of property held for sale in the ordinary course of the taxpayer's trade or business, Maurice Bacon Cooke, T.C. Memo. Op., Dkt. 3446 (February 9, 1945). In Leon C. Curtin, T.C. Memo. Op., Dkt., 7094 (April 30, 1947), the taxpayer over a period of years procured about forty patents or applications covering five or six basic ideas. He assigned several of these to a new corporation, in the organization of which he participated, and received about a one-fifth, but not a controlling, stock interest? He was also made its president and general manager at a salary. He later assigned other inventions to the corporation in consideration for which the corporation undertook the commercial development and exploitation of these products and the payment to the taxpayer of royalties and a share of the sales price in the event of sale of the patents to others. It was the sale by the corporation of several of the inventions which the taxpayer had assigned to it which gave rise to the receipt by the taxpayer of a share of the proceeds of the sale and the subject of the tax involved in dispute. The court held that the inventions involved were not property held by the taxpayer "primarily for sale to customers in the ordinary course of his trade or business" and distinguished the Avery case in the following language:

> "It apnears unmistakably from the facts that petitioner assigned patent rights to a corporation in which he had a considerable stock interest and of which he was the directing head for the purpose of achieving their profitable development and exploitation, using the mechanics of the corporation - assignee to finance such exploitation. It is a far different situation from that in which an inventor makes sales of patent rights to several purchasers in none of which he has any proprietary interest and is motivated solely by obtaining an immediate profit. In the latter case, it can be said, as we held in Harold T. Avery, supra, that the taxpayer is in the trade or business of selling patents to customers. But in ths instant case the

"transfers of patent rights by petitioner to only one corporation in which he had a considerable proprietary interest for the purposes indicated by the facts, do not warrant a finding that he was in the trade or business of selling patents or inventions to customers."

In the light of the foregoing authorities, the Commissioner was not warranted, in our opinion, in determining that the Appellant was engaged in the business of inventing or that the two patents in question were held for sale by him in the ordinary course of a trade or business.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code, that the action of Charles J. McColgan, Franchise Tax Commissioner? on the protest of L. A. Johnson to a proposed assessment of additional personal income tax in the amount of $216.80 for the year 1940 be and the same is hereby modified; said action is hereby reversed in so far as the Commissioner determined that the income from the sale of patents was ordinary income rather than income from the sale of capital assets; in all other respects said action of the Commissioner is hereby sustained,

Done at Sacramento, California, this 17th day of November, 1948, by the State Board of Equalization.

Wm. G. Bonelli, Chairman
J, H. Quinn, Member
J. L. Seawell, Member
Geo. R. Reilly, Member

ATTEST: Dixwell L. Pierce, Secretary