83-SBE-271

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ROBERT H. AND MARY I. ROYSTER)

For Appellants: Robert P. Reddingius and
George H. Zeutzius
Attorneys at Law

For Respondent: Daniel A. Borzoni
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Robert H. and Mary I. Royster for refund of personal income tax in the amount of $9,630.47 for the years 1964, 1965, 1966, and 1967. At all material times, Robert and Mary Royster were husband and wife. They filed a joint tax return for each of the years in question. Mr. Royster died on July 15, 1981, leaving Mrs. Royster as the sole beneficiary of his estate. Mrs. Royster is proceeding with this appeal on behalf of herself and her late husband and hereafter will be referred to as appellant.

There are three issues presented for decision. The first issue is whether the federal determination of deficiency relied upon by respondent in making its adjustments was correct. The second issue is whether respondent's assessments of additional tax for 1964 and 1965 were barred by the statute of limitations, The third issue is whether amounts received in connection with the transfer of certain patent rights should be taxed as capital gain or as ordinary income for the years 1964,. 1965, 1966 and 1967.

Mr. Royster invented a number of hydraulically operated metallic locking actuators to be utilized as parts in the manufacture of aircraft. In May 1961, he filed applications with the United States Patent Office. Two patents were issued to him on October 22, 1963. He obtained a third patent on November 16, 1965, a fourth patent on May 17, 1966, and a fifth patent on September 19, 1967.

By a letter dated December 20, 1961, Mr. Royster entered into an agreement with the Ronson Hydraulic Units Corporation in which the corporation agreed to pay Mr. Royster, as an "engineering service fee", five percent of all receipts from the sale of two locking actuators designed by Mr. Royster and sold by Ronson to the Boeing Company for use in the manufacture of the 727 airplane. The agreement was to be in effect as long as Boeing manufactured the 727 airplane, Eight months later, by a letter dated August 22, 1962, Mr. Royster entered into a second agreement with Ronson in which Mr. Royster agreed to represent Ronson, as an independent contractor, in an engineering and sales capacity. The agreement stated that Mr. Royster would continue to be paid five percent of the net receipts from sales of his locking actuators to the Boeing Company, plus five percent of net proceeds from any new sales that Mr. Royster might generate. A company circular dated August 24, 1962, which was distributed to all Ronson's sales representatives, described Mr. Royster as the inventor of the "Ram Loc" and "Infi Loc" designs and stated that his function was to provide sales support to the local representatives.

On their income tax returns for 4964, 1965, 1966 and 1967, Mr. and Mr. Royster reported the payments received from Ronson as long-term capital gain. The Internal Revenue Service audited appellant's returns and on December 4, 1970, issued deficiency assessments for 1965, 1966 and 1967. The deficiency assessments were

based upon a determination that the payments received from Ronson should have been reported as ordinary income rather than long-term capital gain,

Pursuant to Internal Revenue Code section 6103(b), respondent was furnished information by the Internal Revenue Service regarding the examination of appellant's federal returns. Respondent determined that the federal adjustments were applicable to appellant's state returns. Respondent issued notices of additional tax proposed to be assessed for 1964, 1965, 1966, and 1967. The 1964 assessment became final on June 19, 1970. The 1965, 1966, and 1967 assessments became final on February 16, 1972. Respondent filed liens against property owned by appellant on November 26, 1971, and August 20, 1973. The liens were released on January 15, 1979, when appellant paid the $9,630.47 assessed tax liability. On January 18, 1980, appellant filed a claim for refund. Appellant claimed that the refund should be allowed because the Internal Revenue Service released a federal lien without collection of the federal assessments. Respondent contacted the Internal Revenue Service regarding its release of the federal lien and was informed that the lien was released because the federal statute of limitations for collection of the federal assessment had passed. The federal assessments had not been reversed. On August 18, 1980, respondent denied appellant's claim for refund and this appeal followed.

Respondent bases its denial of appellant's claim for refund on Revenue and Taxation Code section 18451. That section provides that a taxpayer shall either concede the accuracy of a federal determination or state where it is erroneous. Respondent cites Todd v. McColgan, 89 Cal.App.2d 509 [201 P.2d 414] (1949), the Appeal of Willard D. and Esther J. Schoellerman, decided by this board on September 17, 1973, and the Appeal of Willie D. Burks, decided by this board on March 2, 1977, as authority for the proposition that a determination by the Franchise Tax Board based upon a federal audit is presumed to be correct and the burden is on the taxpayer to overcome that presumption. Respondent contends that appellant has not overcome that presumption.

Appellant contends that:

(1) There was no federal determination of deficiency for 1964. Further, the federal deficiency notices for 1965 and 1966 were barred by the federal statute of limitations. Therefore, there was no valid

federal determination for 1964, 1965 and 1966 upon which respondent could base its action.

(2) The assessments for 1964 and 1965 were barred by the four-year statute of limitation period of section 18586 of the Revenue and Taxation Code.

(3) All substantial rights to the patents were transferred to Ronson. Therefore, the payments received qualified for capital gains treatment under Revenue and Taxation Code section 18192.

The first issue for our determination is whether appellant has overcome the presumption that the federal determination relied upon by respondent in making its adjustments was correct.

Appellant first claims that there was no federal determination of deficiency for 1964; therefore, there could be no federal determination upon which respondent could base its action for that year. Respondent has subsequently conceded that the notice of proposed assessment for 1964 resulted from its own independent field audit. Therefore, there was no federal determination of deficiency for 1964.

Appellant next claims that the federal deficiency notice-for 1965 and 1966 was barred by the federal statute of limitations.

Section 6501(a) of the Internal Revenue Code provides that a tax must be assessed within three years after the taxpayer's return is filed. Respondent has not identified any circumstances which take appellant out of the normal limitation period nor do we find any from the record. Appellant alleges in her brief that her federal tax returns for 1965 and 1966 were filed on or about. April 15, 1966., and April 15, 1967, respectively. If these facts are proved, any federal action for 1965 and 1966 would appear to be barred by the three-year statute of limitation. In support of her allegations, appellant has submitted copies of her 1965 and 1966 federal tax returns. The 1965 tax return is signed but undated. The 1966 tax return is neither signed nor dated. We cannot ascertain from this record when appellant's federal tax returns were filed. We note that while appellant makes the same claim of timeliness for her 1965, 1966 and 1967 state returns, the Franchise Tax Board's closeout transcript indicates that these returns were filed in 1970. While this is not evidence of when appellant's federal

tax returns were filed, nor even conclusive proof as to when her state tax returns were filed, it does show an inconsistency in the record and underscore our need for documentation to support appellant's allegations. Since adequate documentation has not been submitted, we cannot conclude that appellant has proved that the federal action for 1965 and 1966 was barred by the federal statute of limitations. Therefore, we find that the federal determination relied upon by respondent for 1965, 1966 and 1967 was timely. However, as discussed above, respondent cannot rely upon a federal determination for the year 1964.

We now consider whether respondent's assessments were barred for 1964 and 1965 by Revenue and Taxation Code section 18586. It is correct, as appellant contends, that section 18586 of the Revenue and Taxation Code provides that a notice of proposed deficiency assessment shall be mailed within four years after the return is filed. However, Revenue and Taxation Code section 18451 requires a, taxpayer to report to the Franchise Tax Board any change in the amount of gross income made by the Commisssioner of Internal Revenue within 90 days after the federal determination becomes final. Revenue and Taxation Code section 18586.2 provides that if a taxpayer fails to report such a change, the Franchise Tax Board may issue a notice of proposed assessment resulting from the adjustment within four years from the date the federal changes became final.

It is undisputed that appellant did not reyort the federal adjustments to respondent. Respondent learned of them only because of its exchange of information agreement with the Internal Revenue Service. Therefore, respondent had four years from the date the federal changes became final in which to issue a deficiency assessment against appellant. The federal changes became final on December 4, 1970. We cannot determine from this record when respondent issued its notices of proposed assessment. However, the 1965, 1966, and 1967 assessments became final on February 16, 1972, well within the four-year limitation period. Since the assessments became final within the four-year period, issuance of the notices must also have been within the limitations period. Therefore, respondent's assessment for 1965 was timely.

Since we have found that there was no federal change for 1964, the normal four-year limitations period of Revenue and Taxation Code section 18586 is applicable for that year. The closeout transcript of appellant's

file indicates that appellant's 1964 tax return was filed timely. However, neither appellant nor respondent has furnished any documentation to show when the notice of proposed assessment for 1964 was issued. Without some proof of that date, we cannot determine that respondent's assessment for 1964 was barred. Absent such a showing, we must find that respondent's action was timely, since the burden to prove otherwise is on appellant.

Having concluded that respondent's assessments for 1964, 1965, 1966, and 1967 were timely, we next consider whether the amounts received for the use of the patents should be taxed as ordinary income or as capital gain. Appellant's claim for capital gain treatment of the amounts received from Ronson is based upon Revenue and Taxation Code section 18192. Section 18192 provides that a transfer of property consisting of all substantial rights to a patent by any holder shall be considered the sale or exchange of a capital asset even if payments received on account of the transfer are made periodically or are contingent upon the use of the property transferred.[1] Thus, for payments to qualify for capital gain treatment under section 18192, "all substantial rights" to the patent must be transferred.

1/ Section 18192 reads as follows:

> 18192. Sale or exchange of patent. 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, regardless of whether or not payments in consideration of such transfer are--
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> (a) Payable periodically over a period generally coterminous with the transferee's use of the patent; or
>
> (b) Contingent on the productivity, use, or disposition of the property transferred.

Section 18192 is substantially identical to section 1235 of the Internal Revenue Code. It is well settled in California that when state statutes are patterned after federal legislation on the same subject,' decisions by the federal courts and administrative bodies are relevant in determining the proper construction of the California statutes. (Andrews v. Franchise Tax Board, 275 Cal.App.2d 653, 658 [80 Cal.Rptr. 403] (1969); Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 (280 P.2d 893] (1955).) To determine whether a transferee has transferred all substantial rights to a patent, federal courts have developed a two-pronged test. They ask:

> (1) What did the taxpayer actually give up by the transfer; that is, was there an actual transfer of the monopoly rights in a patent; and (2) what did the taxpayer retain after the transfer; that is, are any substantial rights retained.

(Kueneman v. Commissioner, 628 F.2d 1196, 1199 (9th Cir. 1980).)

A patent gives the patent holder the monopoly right to make, use, and sell the patented invention during the life of the patent and to exclude others from doing so. To qualify for capital gains treatment, it is this right which must be transferred. (Kueneman v. Commissioner, supra, 628 F.2d at 1200.) Therefore, in order to make a determination of whether a transfer qualifes for the capital gain benefits of section 18192 of the Revenue and Taxation Code, it is necessary to make a factual examination of the nature of the patent rights tranferred and the nature of the patent rights retained.

The evidence presented in this case is not sufficient to enable us to make the necessary analysis of these facts. The only evidence concerning the nature of the contractual arrangement between Mr. Royster and Ronson are the letters of December 20, 1961, and August 22, 1962. These letters do not identify the nature or the quantity of the rights transferred and retained. It is clear, however, that the letters contain no language of sale. They do not give Ronson the exclusive right to make, use, and sell Mr. Royster's locking actuators, nor do they give Ronson the right to forbid others to make, use, or sell the actuators. The terms of the letters do not forbid Mr. Royster to engage in any activity with respect to his designs that he could have engaged in before. Further, the August 22, 1962, letter and the

Ronson circular distributed to sales representatives leave the impression that at least part of the "commissions" to be paid Mr. Royster on new sales could be considered sales commissions rather than royalties.[2/] Therefore, we conclude that appellant has failed to establish that "all substantial rights" to the patents were transferred.

In conclusion, we find that respondent's assessments for 1965, 1966, and 1967 were based upon a valid federal determination and were issued within the time allowed by the statute of limitations. We find that respondent's assessment for 1964 was within the four-year statute of limitations period of Revenue and Taxation Code section 18586. We also find that the amounts received from Ronson should be taxed as ordinary income.

2/ The letter of August 22, states in part:

> For the above services, we will advance you $2,500 per month against any and all commissions for-a period of six months, starting a:; of August 16th and ending February 16, 1963. The commissions involve the present Agreement we have with you dated December 20, 1961. Applicable to the Boeing 727 Airplane and, or any new locking cylinder business that you might generate and accepted by us.

The record does not state what portion, if any, of the payments resulted from sales made by Mr. Royster.

Appeal of Robert H. and Mary I. Royster

ORDER

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 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Robert H. and Mary I. Royster for refund of personal income tax in the amount of $9,630.47 for the years 1964, 1965, 1966, and 1967, be and the same is hereby sustained.

Done at Sacramento, California, this 13th day of December, 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

____________________, Member

____________________, Member