BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 82A-1131
SAM L. AND VIRGINIA L. LEACH	)	

For Appellants: J. Gary McAllister
Attorney at Law

For Respondent: Charlotte A. Meisel
Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Sam L. and Virginia Leach against a proposed assessment of additional personal income tax in the amount of $17,668.02 for the year 1975.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue. In addition, all references to regulations are to regulations of the California Administrative Code as in effect for the year in issue.

The two issues presented in this appeal are: Whether a payment received in 1975 for certain patent rights was taxable at that time; and, if so, whether such payment was entitled to capital gain treatment at the 50-percent rate of exclusion.

In 1974, appellant-husband (hereinafter referred to as "appellant"), a cash-basis taxpayer and an inventor by occupation, developed a process by which he thought hydrogen could be economically removed from water and burned as fuel. He was granted a British patent for this process in November of 1974. On August 15, 1975, appellant entered into an agreement in which he agreed to grant Presley Illinois, Inc. ("Presley") an exclusive license to utilize his invention for residential household units. Apparently, appellant retained all rights to utilize his invention for commercial units. Pursuant to the agreement, appellant received $500,000 upon signing in 1975 with an additional $2,000,000 to be paid upon delivery of a complete unit. Appellant never delivered the unit and Presley brought suit to rescind the above agreement. On October 6, 1978, the suit was settled by a rescission of the agreement whereby the initial payment was ultimately repaid by appellant.

In his 1975 personal income tax return, appellant characterized the $500,000 payment as the receipt from the sale of a capital asset which had been held for more than five years and, accordingly, recognized only 50 percent of the amount received. (Rev. & Tax. Code, § 18162.5, subd. (a)(3).)[2/] Upon audit, respondent determined that appellant was not entitled to capital gain treatment and subjected the entire $500,000 to taxation.

On appeal, appellant contends the receipt of the $500,000 in 1975 should not be subject to any tax since the underlying contract was rescinded in 1978 and the $500,000 was ultimately repaid by him to Presley. Because of the rescission, appellant concludes that the subject contract was void at the outset with the resulting

2/ In addition to receipt of the $500,000, appellant received $10,000 in 1975 as payment for an option to enter into the agreement. On his 1975 return, appellant characterized this $10,000 as receipt from the sale of a capital asset held for longer than five years, but on appeal concedes that it should be taxed as ordinary income. (Rev. & Tax. Code, § 18191.)

effect that the $500,000 was converted into a loan, a nontaxable event. In conjunction with this theory, appellant argues that he should be entitled to file an amended return for 1975 reflecting his new theory. Respondent, on the other hand, concludes that based upon the annual accounting concept which requires determination of income at the close of each taxable year without regard to subsequent events, the rescission in 1978 had no effect on the receipt of the $500,000 payment in 1975.

Moreover, respondent contends that since appellant apparently retained the right to develop his patent for commercial purposes, he did not transfer all the substantial rights of such patent and, as a consequence, the transfer could not be considered a sale or exchange of a capital asset under section 18192. Respondent also argues that even if the patent was found to be a capital asset, since appellant obtained his patent in November of 1974 and sold his rights in August of 1975, his holding period was less than one year. (Rev. & Tax. Code, § 18162.5, subd. (a)(1).) Under either theory, respondent concludes that 100 percent of the payment must be taxable in 1975. Appellant counters that if the $500,000 should be found to be taxable in 1975, he should be entitled to exclude 50 percent of the payment as the sale of a capital asset held for longer than five years. Appellant contends that his "intellectual property" was developed prior to the issuance of the patent (i.e., at least five years before) and that the sale to Presley had the substantial economic effect of transferring all his rights in the patent.

A careful review of this record and pertinent decisions reveals that appellant's argument with respect to the tax effect of the 1978 rescission is in error. In the Appeal of Anthony C. and Cecilia I. Rossi, decided January 6, 1981, we summarized the law as follows:

> It is well established that if a taxpayer receives funds under a claim of right, without restriction as to their disposition, such funds are includible in income in the year of receipt, even though it may subsequently turn out that the taxpayer is obliged to repay all or a portion of the amount received. (North American Oil Consolidated v. Burnet, 286 U.S. 417 [76 L.Ed. 1197] (1932); Healy v. Commissioner of Int. Rev., 345 U.S. 278 [97 L.Ed. 1007] (1953).) This rule is based on the annual accounting concept which requires

> determination of income at the close of the taxable year without regard to subsequent events. (United States v. Lewis, 340 U.S. 590 [95 L.Ed. 560] (1951); Burnet v. Sanford & Brooks Co., 282 U.S. 359 [75 L.Ed. 383] (1931).)

Accordingly, appellant's argument that the subsequent rescission of the contract voids the transaction converting the money received into a loan is without merit. Even where there is a later rescission of a valid contract, the gain received from the property originally transferred must be reported by a cash-basis taxpayer in the year when it is received. (Appeal of Anthony C. and Cecilia I. Rossi, supra.)3/

Next, appellant argues that if the $500,000 payment for the patent is taxable, it should be taxed as a capital asset held for more than five years. (Rev. & Tax. Code, § 18162.5, subd. (a)(3).) Respondent, on the other hand, argues that the $500,000 payment should be taxed as ordinary income. We note intially that it is well settled that respondent's determination of tax is presumed to be correct, and that the taxpayer has the burden of proving it erroneous. (Appeal of Ronald W. Matheson, Cal. St. Bd. of Equal., Feb. 6, 1980; see also, Todd v. McColgan, 89 Cal.App.2d 509 [201 P.2d 414] (1949); Appeal of David A. and Barbara L. Beadling, Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of Myron E. and Alice Z. Gire, Cal. St. Bd. of Equal., Sept. 10, 1969.) Respondent's primary basis for subjecting the $500,000 to tax at ordinary rates is based upon its reading of section 18192, which provides in relevant part: "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. . . ."

California Administrative Code section 18192-18195(b), subd. (2), defines "all substantial rights to a patent" as follows:

3/ The cases cited by appellant (e.g., Long v. Newlin, 144 Cal.App.2d 509, 512 [301 P.2d 271] (1956)) hold that after rescission, a contract is void ab initio only as between the parties to the contract, but not, for example, to third party creditors. Accordingly, appellant's reliance upon this line of cases is misplaced.

> The term 'all substantial rights to a patent' means all rights which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction.

Respondent notes that the instrument of transfer restricts the transferee's use of the patent to the residential market.[4/] Respondent concludes that all substantial rights to the subject patent were not transferred since other markets, for example, commercial, were available. Accordingly, respondent argues, section 18192 does not apply to the instant transfer and the tax consequences of that transfer must be determined under other provisions of the law. (Cal. Admin. Code., tit. 18, reg. 18192-18195(a), subd. (2).)

We agree with respondent. Appellant has made no showing that he transferred all substantial rights to his patent in 1975. Under these circumstances, we must conclude that the transfer does not qualify for capital gains treatment under section 18192.

The conclusion that section 18192 is inapplicable does not necessarily end our inquiry. Section 18192 is substantially identical to section 1235(a) of the Internal Revenue Code of 1954. At the federal level, it is still an open question whether section 1235(a) is the exclusive means by which a holder's transfer of his patent rights may qualify for capital gains treatment. (Compare Poole v. Commissioner, 46 T.C. 392 (1966), with Treas. Reg. § 1.1235-1(b) and Rev. Rul. 69-482, 1969-2 C.B. 164; see also Omholt v. Commissioner, 60 T.C. 541 (1973); Cal. Admin. Code, tit. 18, reg. 18192-18195(a), subd. (2); Rev. Rul. 78-328, 1978-2 C.B. 215.) We need not resolve this question here, however, since there is nothing in the record to indicate that the transfer in

4/ The relevant paragraph of the agreement provides:

> WHEREAS, PRESLEY . . . desires to be exclusive licensee of . . . such patents . . . insofar as the field of RESIDENTIAL HOUSEHOLD (UTILIZATION) UNITS . . . .

question would be eligible for preferential capital gains treatment under any other provision of the law. Appellant has the burden of proving facts which entitle him to the benefits of the capital gains provisions. (United States v. Wernentin, 354 F.2d 757, 762 (8th Cir. 1965).) In order to obtain such preferential treatment, appellant must show that the subject patent was a capital asset in his hands which he held for the applicable holding period. Since appellant has not met this burden, we must conclude that respondent properly treated the payments in question as ordinary income.

Therefore, based upon the record before us, we must sustain respondent's action in its entirety.[5]

5/ Because of this conclusion, we do not have to address appellant's argument concerning amendment of his 1975 return.

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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 the Franchise Tax Board on the protest of Sam L. and Virginia L. Leach against a proposed assessment of additional personal income tax in the amount of $17,668.02 for the year 1975, be and the same is hereby sustained.

Done at Sacramento, California, this 9th day of October, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr., Chairman

Conway H. Collis, Member

William M. Bennett, Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9