

## LES MIDWESTERN REGIONAL MEETING

Monday, May 7, 1973  
Dearborn Inn, Dearborn, Michigan

The theme of the Midwestern Regional Meeting of LES was "Let Us Reason with One Another," which was planned, principally as a program of working sessions to give the attendees an opportunity for full discussion of all aspects of four topics. This type of program and the topics were developed in response to an LES questionnaire to members.

Donald W. Banner, as Meeting Chairman, gave the welcoming remarks; Vincent E. Young, Vice-President, Midwest Region, LES, and Charles H. Chappell, President of LES, also welcomed the group of about 50 who were present.



*Vincent E. Young*



*Donald W. Banner*



*Charles H. Chappell*

The four topics chosen for discussion, their leaders, biographical material, and photos appear below:

**"Tax Considerations in Licensing: Incentives for Invention"; Moderator, William Marshall Lee.**



Wm. Marshall Lee is the founder of a new Chicago law firm specializing in intellectual property, licensing, and related antitrust matters, having specialized in

these fields for twenty years with another Chicago law firm of which he was a name partner. He has a B.S. degree in aeronautical engineering, with graduate work in mechanical engineering and in thermodynamics, through attendance at the University of Wisconsin, Aeronautical University of Chicago, Dartmouth College, Pratt & Whitney Army-Navy Engine School, and the University of California at Los Angeles. His legal training was taken at Loyola University of Los Angeles and Loyola University of Chicago from which he received a J.D. degree. Mr. Lee is past chairman of a number of bar association committees involving federal civil procedure, inventors, taxation, and antitrust, and he is currently Chairman of the Patent Law Revision Committee of the American Bar Association Patent Section. He is also Chairman of the ABA Coordinating Committee which drafted the proposed new "Patent Law Modernization Bill" of November, 1972. Mr. Lee has spoken at a number of bar association and industry meetings on a number of legal subjects including civil procedure, inventor's tax problems, patent litigation, patent law revision, and patent antitrust. He is currently Chairman of the LES Committee on Laws.

With the permission of our President and our Chairman, I am going to deviate slightly from the broad subject matter of taxation in licensing and go into something more specific and yet vital. Let me give you a little of my reasoning.

Incentives are a very, very important aspect of development of the technology in which we deal and which we transfer by licensing. Without incentives we stifle the development of technology, that is, we stifle invention. Then we have nothing to transfer. This, of course, is basic. Let me be a little more specific. I am speaking about motivation, incentive for that very fragile commodity in this United States, that is, the American inventor. By and large the American inventor has been poorly treated in recent years. He has been patted on the back and then kicked in the teeth for many, many years; and I believe it is showing. I think it is one of the reasons for the adverse technological trade balance, gone negative for the first time in 100 years. Perhaps things are going to be done about this, at least I hope so.

What we desperately need to do is to bring back the incentive for the inventor, for the developer of technology. If we do not do this, we are lost. After all, we in these United States export what we refer to as high technology goods. And yet while other countries are praising, helping and rewarding their inventors, many of our courts are unthinkingly saying, in essence, that anything a court can understand is obvious and therefore unpatentable and unprotectable. We are losing out in the invention race as a result.

Getting more into the subject the workshop will deal with, the subject of taxation, you may remember that many years ago our famous Chief Justice, John Marshall, said "The power to tax involves the power to destroy." Very important. Our Civil War President, Abraham Lincoln, said "The patent system adds the fuel of interest to the fire of genius." By conclusion from these premises, and in actual fact, taxation can diminish or destroy that fuel, or it can provide a means for increasing the incentive of the inventor.

Happily, we have an incentive enhancing provision in our tax laws, Section 1235 of the Revenue Code of 1954. Section 1235 deals with the sale or exchange of patents. It has been used primarily in the area of exclusive licensing of patents and in the outright sale of patents. In such situations, under §1235 the return to the inventor is taxed at the capital gains rate. This is a very important consideration as all of you know who have dealt with inventors.

Prior to the 1954 act there was a dichotomy, a discrimination between so-called amateur inventors, those who make one invention, and the professional inventor who has made more than one. An invention is not stock on trade for an amateur inventor, and therefore, when he sells his patent he is entitled to long term capital gain treatment. For the professional inventor, the more important who has come up with more than one invention, patents are stock in trade and when he sold them prior to the enactment of §1235, the proceeds were treated as ordinary income. This was not right, and the courts sought to rectify the law, resulting in the enactment of §1235 which does rectify it in a limited sense.

§1235 does not discriminate between classes of inventors. It provides that a patent is considered an asset held for more than six months, and if the inventor transfers "all substantial rights" to the patent, he is

entitled to long term capital gain treatment. If he sells his patent outright, there is no question. An important use of this statute has been in exclusive licensing. The courts have held that an exclusive license of a patent is a transfer of all substantial rights, tantamount to a sale for tax purposes. Many inventors have taken this route. They approach a company and exclusively license their patents. Now this is all well and good and clearly nets long term capital gain treatment where the exclusive license covers the patent without limitation. However, many, if not most inventions are useful in not just one field but a number of fields. In such situations inventors rightly and properly assign a particular field by exclusive license to a particular company. This usually makes the company happy and the inventor happy. The inventor is then free to go elsewhere and proliferate the subject matter, which otherwise probably would not be promoted.

The IRS attacked such field of use licensing, saying that the inventor had not transferred all substantial rights in his patent. In fact, the IRS regulations presently state specifically that a field of use exclusive license is not a transfer of all substantial rights. However, the courts have uniformly held against the IRS and have held that field of use exclusive licenses are entitled to long term capital gain treatment. And in this sense, God love 'em (the courts that is).

However, there is another aspect to §1235 which should be explored and used more to provide additional incentive to inventors, to further motivate them to make the inventions our country needs so badly. This is the aspect of transfer by inventors to companies in which they have an interest. §1235 provides specifically by reference to another section, that an inventor can transfer a patent to a corporation of which he owns less than 25% of the shares and still maintain long term capital gain treatment for the proceeds. See what this does. It provides that the inventor can assign his patented inventions to a corporation in return for a contract for a percentage of the return. The statute specifically provides that regardless of the form of the return, a percentage or a royalty, or that sort of thing, it is still entitled to long term capital gain treatment. In addition to this return on which the inventor is entitled to long term capital gain, formation of such a corporation still provides the inventor a partial say in the manner of transfer of the technology to others.

With such a corporate arrangement the inventor is also entitled to his share of the corporate profit, along with the other shareholders. A difficulty is encountered here, however. I will not go into the details because I suppose the workshop will get into these. One of the problems is that such a company, a development company which has the major portion of its income in the form of royalties, is a personal holding company, so that to avoid confiscatory taxation, all of the profit in any year must be distributed in that year. Thus, the corporation cannot accumulate money for further development, and, of course, the distributed earnings are subject to double taxation, corporate tax on the whole and individual tax on each shareholder's portion.

One more feature of §1235 should be explored. It

provides that long term capital gain treatment is afforded to return on transfer of all substantial rights by a "holder." "Holder" is specifically defined as a person whose efforts created the property, the inventor to whom we have referred, or to any other individual who acquired his interest "prior to the actual reduction of practice of the invention covered by the patent." Thus, it provides that an individual (not a company) who is willing to put up his money and take a flyer with an inventor, is entitled to special tax treatment if he transfers his rights by sale or by exclusive license. The problem is, of course, the investor who comes in *after* reduction of practice but who also puts in his time, effort and money is discriminated against, that is, he is not entitled to long term capital gain treatment.

Well, there are many ramifications to this fine statute which are still not well thought out. There are also ways in which it could be improved by amendment to further enhance the promotion of invention.

Now, Mr. Chairman, I hope you will not mind if I close with the "Taxpayers Slogan." The taxpayer's slogan is *Tax Vobiscum*, which roughly translated from fractured Latin means "tax be to you — not to me."

**"Arbitration to Settle License Disputes"; Moderator, Robert Alden Choate.**



Robert Alden Choate was born in Grand Rapids, Michigan in 1912; attended high school in Greenville, Michigan; Engineering Degree at University of Michigan in 1934; Law Degree at University of Michigan in 1936. He practiced with the firm now known as Barnes, Kisselle, Raisch & Choate of Detroit, Michigan since 1936 with the exception of a period with the office of the Judge Advocate in World War II; field of specialty is Patent, Trademark and Copyright Law. His family consists of four children.

Extra curricular activities include President of The Michigan Patent Law Association in 1963-64; past Board of Managers, Michigan Patent Law Associa-

tion; Acting president of the Board of Management of the Downtown Y.M.C.A. 1964-1967, Chairman; world Service Committee, Downtown YMCA; guest lecturer Engineering Society of Detroit, Patent Law Seminar; and author of several published articles on patent law and related matters; Congregational Church, soloist and choir member; Detroit Council of Churches Finance Committee; Family Life Committee, Michigan Conference of United Church of Christ; active member in the Detroit Bar Association, State Bar of Michigan, and the American Patent Law Association. While in Engineering School was a member of Tau Beta Pi. Lecturer in Patent Law at the University of Michigan Law School since 1960. Author of case-book on Patent Law, West Publishing Co., 1973.

#### *Arbitration to Settle License Disputes*

An old Russian proverb reads: "Put your foot in the court room; put your hand in your pocket." It is general knowledge that litigation in the courts is slow, expensive, and fraught with many other difficulties, not the least of which are unfavorable publicity, damage to credit ratings, disruption and diversion of staff activities, and possible tie-up of bank accounts. While still a circuit judge, Chief Justice Warren Burger said:

"One thing an appellate judge learns very quickly is that a large part of all the litigation in the courts is an exercise in futility and frustration. The anomaly is that there are better ways of resolving private disputes, and we must in the public interest move toward taking a larger volume of private conflicts out of the courts and into the channels of arbitration."

All this being true, it behooves licensing lawyers and executives to examine alternative methods of settling disputes. Arbitration thus comes into focus. It is not new in the history of civilization, and mythology provides the story of the Trojan Paris, serving as an arbitrator to determine the most beautiful among the goddesses Hera, Athena and Aphrodite. Since he survived the assignment, we can assume it was successful and it will be remembered that there were efforts to corrupt the arbitrator. Apart from use by the New York Chamber of Commerce as early as 1786 in the United States, arbitration did not become an effective tool until 1920 when a New York statute gave legal standing to the agreements to arbitrate made before a dispute arose.

The organization of The American Arbitration Association in 1922 proved the beginning of a service which has expanded into every state and provided a panel of 20,000 persons who have volunteered to serve without remuneration in the settling of disputes. The advantages attributable to arbitration are speed, economy, expert consideration by selected arbitrators, privacy, and a minimum of legal limitations. The arbitration proceedings, well outlined by accepted procedures, is an orderly process wherein disputes may be adjudicated quickly. The word "adjudicated" is used advisedly since the proceedings is to be distinguished from mediation, conciliation, compromise or settlement. The arbitrator makes an award and this award