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Professor's Receipt of Royalties Treated As Capital Gains

In a Technical Advice Memorandum¹ made public late last year, the IRS concluded a university professor is entitled to capital gain treatment for royalties received from his employer in exchange for rights in a patent to the professor's invention.

Facts

The professor is a party to a collective bargaining agreement with the university. The agreement, adopting certain portions of the State's Administrative Code, provides that an invention made by a university employee in the employee's field or discipline or using university support is the property of the university. In these circumstances, the employee shall share in the proceeds from the invention.

In the course of performing research, the professor developed an invention, filed a patent application for the invention, and assigned the patent to the university. The professor executed a royalty agreement with the university that provides for payments based upon a percentage of the receipts derived from the sale of the invention. The university treated the payments as royalties and not salary or wages.

IRS Conclusion

The IRS concluded the payments were not compensation for services but instead were for the transfer of the professor's patent rights and, thus, were subject to capital gain treatment.

PwC Observes

The IRS typically relies on several factors to support its conclusion that royalty payments are eligible for capital gain treatment:

- The employee was not "hired to invent."
- Payment of royalties to the employee would continue beyond the employment relationship for the entire life of the patent.
- Royalty payments are connected to the transfer of the rights to an invention rather than compensation for services.

¹ Technical Advice Memorandum ("TAM") 200249002 (December 6, 2002). While a TAM may not be used or cited as precedent, it does provide insight as to how the IRS would rule in a similar situation.

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FYI. Judy

- The amount of payment to be received by the employee is dependent on use or value of the licensing of the patent.

Finally, the IRS states that despite the State Administrative Code's provision that invention rights are the property of the university, the state law does not usurp the federal principle that initial patent rights vest with the inventor.

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