PHOTOCIRCUITS CORPORATION v. U.S.

34 AFTR 2d 74-5211, (Ct Cl)

1.JUDICIAL PROCEEDINGS-Jurisdiction of courts-new matter on appeal. IRS' Sec. 269 defense to refund suit was raised too late. Issue wasn't presented until after Ct. of Claims trial judge's recommended decision.

2.INCOME-To whom taxable-corporation or stockholder-transaction between corporation and stockholder. Separate corporate entities upheld. Corporations were formed for valid business reasons and carried on substantial business activities.

3.CAPITAL GAINS AND LOSSES-Patents-special rules-sale or exchange. Capital gains treatment allowed. Sale and lease-back of inventions between related corporations wasn't sham transaction. Purchase price agreed on by corporations' experts was fair. Because of secrecy of inventions outside valuation wasn't possible. Capital gains denied in separate transaction where there was no bona fide business purpose.

4.BUSINESS EXPENSES-Rental and royalty payments-payments to related parties-deductions under sale and lease-back arrangements. Business expense deduction allowed in part for royalty payments. There were valid business purposes for sale and lease-back agreement between related corporations and for having another corp. acquire invention and licensing it to its related corp. Deduction was denied for one transaction; there was no valid purpose for licensing agreement between related corporations.

OPINION

Before COWEN, Chief Judge, SKELTON and KASHIWA, Judges.

Order

This case comes before the court on defendant's motion for rehearing of that portion of our Order of March 29, 1974, which in Paragraph No. 2 held that the burden of proof with respect to defendant's claimed offset for the year 1961 rests upon the defendant. Upon consideration of the motion, plaintiff's response thereto, and upon examination of the documents in the record, we find that there is both confusion and doubt as to whether defendant in the prooceedings prior to the trial of this case met the requirements set forth in Missouri Pacific R.R. v. United States, 168 Ct.Cl. 86, 338 F.2d 668 [14 AFTR 2d 5948] (1964), by raising the setoff issue within the time and manner required by that case to place the burden of proof as to the setoff on the plaintiff. Since we have concluded that this issue can best be resolved by the trial judge,
It Is Ordered that that part of Paragraph No. 2 of the Order of March 29, 1974, relating to the burden of proof on the setoff is amended to provide that the question as to which party has the burden of proof is hereby remanded to the trial judge for a determination by him.
[Order dated 3-29-74]

Order

These cases come before the court on plaintiffs' and defendant's exceptions to the recommended decision filed June 21, 1973, by Trial Judge Harry E. Wood, pursuant to Rule 134(h). Upon consideration of the briefs and exceptions of the parties and after hearing oral argument, the court agrees with the trial judge's results (although not necessarily with all of the statements in his opinion) and with his findings of fact and Recommended Conclusions of Law, which are hereby adopted as a basis for the court's judgment in these cases. Copies of the trial judge's recommended decision and findings of fact have previously been furnished to the parties. Since the cases must be remanded to the trial judge to determine the amounts to be recovered, the court adds the following as a supplement to this decision for guidance in the conduct of further proceedings in the cases:

(1) The Section 269 issue After the trial judge's recommended decision had been filed and for the first time in the long administrative and judicial history of these cases, the defendant in its brief to the court asserted that plaintiffs' recovery is precluded by Section 269 of the Internal Revenue Code of 1954. Unlike Commissioner v. Gordon, 391 U.S. 83, 95 [21 AFTR 2d 1329], fn. 8 (1968) upon which defendant relies, the Section 269 defense involves an entirely different section of the Code than was mentioned at any time in either the administrative proceedings or during the trial in this court and also involves disputed issues of fact. See Cromwell Corp., et al. v. Commissioner, 43 T.C. 313 (1964). Had the defendant timely presented this issue, plaintiffs, upon whom the burden of proof would have rested, would have had an opportunity to present evidence which might have resulted in findings of fact in their favor. The defendant's belated raising of an issue that was not in the case is not only in derogation of our Rule 134, but we are highly doubtful that the findings which the defendant requests us to make on the present record, would be justified in view of the trial judge's determination that ETCO and Day were viable entities created for business purposes. We, therefore, conclude that defendant has raised the defense too late in these proceedings, and it will not be considered. WRB Corp. et al. v. United States, 183 Ct.Cl. 409 (1968); J. G. Watts Construction Co. v. United States, 174 Ct.Cl. 1, 355 F.2d 573 (1966); cf. Trans Ocean Van Service v. United States, 200 Ct.Cl. 122, 470 F.2d 604 (1972).

(2.) The setoff issue in pretrial proceedings before the trial judge, the defendant raised a setoff issue regarding royalty payments which Day received from Photocircuits European licensees in 1962, a taxable year which is not in issue in these cases. The trial judge correctly concluded that the burden of proof on the issue for the year 1962 was upon defendant; that defendant failed to discharge its burden, and that defendant's contention should be rejected. This decision as to 1962 is affirmed in all respects. However, the defendant now says that its reference to "the year 1962" was a typographical error and that plaintiffs should have realized the defendant meant "the year 1961." The trial judge has concluded that Day had such income in the year 1961; that defendant may have intended to refer to that year, and that in such a complex case, the interests of justice require that the issue should be fully explored and resolved in the remand proceedings under Rule 131(c). Therefore, and pursuant to the provisions of Rule 42, we accept the defendant's statement that a typographical error was made and remand the issue to the trial judge for determination along with the other issues relating to the right of recovery. If defendant had raised the setoff issue in a timely and correct manner, the burden of proof on the setoff would have been upon the plaintiffs. Missouri Pacific R.R. v. United States, 168 Ct.Cl. 86, 338 F.2d 668 [14 AFTR 2d 5948] (1964). However, in view of the failure of the defendant to raise the issue correctly in a timely manner and its lack of diligence in discovering and correcting the typographical error, we hold that the burden of proving this offset rests upon the defendant.

The court therefore concludes, as a matter of law, that:

Plaintiff in Photocircuits Corporation v. United States, No. 28-69, is entitled to recover, and judgment is entered to that effect. Absent a stipulation of the parties as to the amount of recovery due such plaintiff, that amount less any offset found in favor of defendant is to be determined in further proceedings pursuant to Rule 131(c) in accordance with this order;

Plaintiff in Powers Chemco v. United States, No. 62-69, is entitled to recover with respect to the "constructive" dividend issues relating to its fiscal year ended August 31, 1962 but is not entitled to recover with respect to the royalty expense issue relating to its fiscal year ended August 31, 1963, and judgment is entered to that effect. Absent a stipulation of the parties as to the amount of recovery due such plaintiff, that amount is to be determined in further proceedings pursuant to Rule 131(c) in accordance with this order; and

Plaintiffs in Robert Page Burr and Elizabeth Long Burr v. United States, No. 139-69, are not entitled to recover on the capital gains issue for 1963, and judgment is entered to that effect. All other issues relating to Mr. Burr's income tax liability and/or refund due for 1963 are to be determined by the trial judge along with the other matters remanded to him by this order.

Trial Judge's Opinion

Judge: WOOD, Trial Judge:

In these three separate actions, plaintiffs sue to recover federal income taxes and interest. The interrelationships between the plaintiffs are complex, and the transactions out of which the said actions arise are several, intricate, and, at least to some degree, inseparable. Although the relevant tax years, and issues still viable, 1 are not identical, the cases were consolidated for trial because of common issues of law and fact. 2 Their joinder herein, in the interests of clarity and brevity, seems entirely appropriate.

The facts, fully detailed in the accompanying findings, will first be set forth as briefly as comprehensibility permits.

I. The Plaintiffs.

(a.) Powers Chemco, Inc. ("Chemco"). Chemco, a New York corporation formed in 1904 by two brothers (Augustin J. and Frank T. Powers), sues to recover federal income taxes and deficiency interest paid for the years ended August 31, 1962, and August 31, 1963. 3 In 1962 and 1963, Chemco was a manufacturer and dealer in the graphic arts and photoengraving industries. Its ownership and management during that period are described in the findings. Briefly, its non-voting, dividend paying, common stock was then owned equally by eight Powers family "branches" (composed of descendants of the two founders, with each "branch" headed by a child of a founder), and its voting common stock was held, albeit not equally, by seven of the founders' eight children. Its officers and directors then included five of those children, John D. Maxwell (the husband of another child), and other members of the Powers family.

(b.) Photocircuits Corporation ("Photocircuits"). Printed circuit boards, which consist of insulating material on which conductive material is laminated in a preconceived pattern, are used as components of electrical and electronic devices. During the period ending in 1949, there was no printed circuit industry, but in 1949 or 1950 Chemco became aware of the opportunities in this field, and Robert Swiggett, then a development engineer with Chemco, was directed to investigate its potential. As a natural outgrowth of Chemco's photoengraving business and research and development, Photocircuits was formed in 1951 to engage in the manufacture of printed circuit boards. Its ownership, and its management in 1960 and 1961, 4 are detailed in the findings. Briefly, Mr. Swiggett owned 6 percent of Photocircuits' stock from its formation to at least September 1962. The balance of such stock was owned to 1957 by the eight children of the founders of Chemco, from 1957 to September 1962 by Chemco, and from September 1962 equally by the eight Powers family branches alluded to heretofore. Its officers and directors in 1960 and 1961 included Mr. Maxwell, the five children of the founders of Chemco who were also officers and directors of Chemco, and Mr. Swiggett. When Photocircuits was formed in 1951, United States rights to the only method of making printed circuits then known (the "etched foil" process) were owned by Technograph of America. Shortly after Photocircuits began marketing operations, Technograph of America asserted infringement of its patent rights by Photocircuits, and a license agreement covering the said rights, and calling for payment by Photocircuits of a royalty of approximately 1 percent of net sales of licensed products, was subsequently negotiated.By 1957 or 1958, competition in the printed circuit industry (which to that time largely involved making boards on order) had become quite severe. Photocircuits endeavored to meet these problems by developing both patentable technology of its own and new products it could manufacture and stock for sale to customers. By 1958, it had made some progress on a new method (called the CC-4 process) of making printed circuit boards. The thrust toward development of patentable technology of its own ultimately led to a foreign licensing program described hereinafter. The thrust toward new product development led in 1958 to the formation of Circuit Research Company.

(c.) Robert Page Burr. 5 Photocircuits' in-house efforts toward new product development proved to be unsuccessful because of a tendency of engineers assigned to that effort to be continuously involved in the manufacturing process. Accordingly, about 1957 Photocircuits began a search for a product engineer who could operate outside its established research program and manufacturing activity to develop new products which it could manufacture or license. Mr. Burr, a highly qualified electronics engineer, knew, and was known to, various officers of Photocircuits. For personal reasons he was interested in establishing a relationship with Photocircuits, but with maximum autonomy to pursue ideas he believed feasible, and an equity interest in any invention or product he might create. After Mr. Burr's rejection of an offer of a job with Photocircuits, and consideration and rejection of a separate research and development corporation, a partnership, known as Circuit Research Company ("CRC"), was formed as of February 1, 1958, to conduct research and development and such other business as agreed to by the partnership. Mr. Burr, Mr. Swiggett, and the eight children of the founders of Chemco were partners in CRC. Mr. Burr had a 10 percent interest in the profits and losses of the partnership, and he was its managing partner. CRC and Photocircuits entered into an agreement, dated April 15, 1958, providing that CRC would undertake research and development projects for Photocircuits relating to products then being manufactured or in which Photocircuits might become interested in the future. CRC also agreed to advise Photocircuits of all discoveries or inventions by CRC while working on R&D projects for Photocircuits, and to afford Photocircuits first opportunity to use any patents, processes, or methods, or manufacture or sell any products CRC might discover or perfect, at a reasonable license fee. Photocircuits agreed to pay to CRC "the costs of these projects" (specifically, staff time and direct technical supervision; materials and supplies; miscellaneous expenses; necessary special equipment; rental costs; travel expenses; and freight and express).CRC originally operated from its own separate location. It had a checking account and payroll account at local banks, paid its suppliers, retained its own patent counsel, employed a consultant, and applied for and received patents in its own name. It prepared and submitted to Photocircuits a budget and cash flow estimate, and also periodically submitted statements of "costs" to be borne by Photocircuits under the April 15, 1958 agreement. While reports on the activities of CRC were frequently presented at meetings of Photocircuits' board of directors, and Mr. Burr frequently appeared personally to make such reports, CRC was not required to, and did not, limit its activities to products which could be manufactured or licensed by Photocircuits.In 1960, space became available at Photocircuits' plant. To obtain access to Photocircuits' inventory of tools and equipment and to improve communications, CRC moved to that location, operating therefrom through 1965. At Photocircuits' plant CRC occupied its own severable portion of the plant with its own entrance, maintained its own telephone number and confidential disclosure cards for visitors, and posted a sign on the premises indicating its name and the location of its entrance.In 1959, in accordance with its contractual right to do so, Photocircuits entered into license agreements with CRC relating to crosspatch interconnection boards and printed motors and their components, at a royalty rate (initially 10 percent) based upon Photocircuits' net sales of products using the licensed technology. By agreement dated November 25, 1960, then applicable royalty rates on the technology were reduced to 2 percent.CRC was dissolved in 1965 or 1966. Upon its dissolution Mr. Burr became a stockholder of Photocircuits. He owned no stock in Photocircuits, or in Chemco, during [pg. 74-5215]or at any time prior to 1963.

II. Photocircuits' Foreign Licensing Program

Printed circuit manufacture is essentially a service business. In 1956-58, Photocircuits was an acknowledged leader in the printed circuit field, and various European manufacturers were interested in learning of its technology and know-how. In Photocircuits' judgment at that time, however, doing business with foreign customers on a service basis was for several reasons infeasible. There were, however, other possible avenues of exploitation, and about 1957, Photocircuits' officers began to investigate the European printed circuit market.

Technograph Printed Circuits, Ltd., London ("Technograph") owned European patents on the etched foil method of making printed circuits, and in the course of visits to Europe about 1957, Mr. Swiggett engaged in discussions with officials of Technograph and other companies. Sometime in 1957, as a part of its program of entry into the European market, Photocircuits retained as a consultant Dr. Karl A. Egerer, an independent contractor with broad qualifications and extensive experience in foreign licensing.

In 1958, Photocircuits commenced a program of licensing printed circuit technology in Europe. Its first licensee was Ruwel Werke ("Ruwel") of Geldern, Germany, the largest European manufacturer of printed circuits at that time. Ruwel received the exclusive right and license under Photocircuits' pending and future patent applications to manufacture and sell printed circuits in Germany, Austria, Belgium, Switzerland, and Scandinavia, and Photocircuits received similar license rights to use Ruwel's patents and pending patents in areas outside the territory granted to Ruwel. The Photocircuits-Ruwel agreement also provided for an exchange of know-how between the parties, with new developments to be transmitted through yearly visits to Ruwel by a technical representative of Photocircuits at the latter's expense. Ruwel agreed to pay

Photocircuits, for both technology and know-how, a royalty at the rate of 2 ½ percent of net sales. 6

About 1959, the desirability of an accommodation with Technograph became obvious to Photocircuits. After some negotiations, Dr. Egerer became a joint licensing agent for Photocircuits and Technograph and joint licensing agreements were negotiated.
On July 1, 1959, Photocircuits entered into an agreement with l'Air Liquide of Paris, France, the terms of which were virtually identical to the Photocircuits-Ruwel agreement, except that l'Air Liquide became Photocircuits' exclusive licensee in France, Monaco, Morocco, Tunis [sic], Vietnam, Laos, Cambodia and Guinea.

Pursuant to its agreements with Ruwel and l'Air Liquide, Photocircuits provided the two licensees with know-how relating to the manufacture of printed circuit boards. Photocircuits also furnished instructions to representatives of the two licensees at its New York plant. After the initial transfer of know-how, late in 1958 and in 1959, Photocircuits' personnel (usually Dr. Egerer) visited the licensees each year to update technical information. In the 1958-59 period, Photocircuits also received from Ruwel know-how which Photocircuits used in its manufacturing processes.

During 1959 and 1960, Dr. Egerer received royalty payments due Photocircuits and Technograph under their foreign licensing agreements, paid therefrom various expenses involved with the licensing program (incurred mainly by Dr. Egerer, but in part incurred by the licensors in transmitting know-how), and deducted therefrom his own fee for servicing the foreign licensing program. It is reasonable to conclude that the net amount due each licensor from the foreign licensing program thus far described was ultimately paid over to it by Dr. Egerer.

III. The Creation of the Bahamas Trusts, Day, and ETCO

Late in 1960 or early in 1961, as part of an elaborate scheme designed by a law firm which represented Chemco and Photocircuits, 114 Bahamas trusts were established. The facts surrounding their creation are detailed in the findings. Briefly, the beneficiaries included Mr. Burr (six trusts), Mr. Swiggett and Mr. Maxwell (12 trusts each), and seven of the eight children of the two founders of Chemco (12 trusts each).

Peter Graham, a Bahamas attorney,was named trustee of each of the 114 Bahamas trusts. The advisory committee for each trust consisted of a member of the law firm which represented Chemco and Photocircuits and the spouse (or in one instance the brother) of the beneficiary of the trust. The trustee was [pg. 74-5216] given broad powers but was authorized to follow (and indemnified for following) instructions of the advisory committee. The advisory committee had the power (inter alia) to remove the trustee.

After commencement of its foreign licensing program, Photocircuits had discussed with its (and Chemco's) counsel the matter of an organizational structure that would optimize that program and best serve Photocircuits in meeting its objectives. The decision ultimately reached, and effectuated, was to set up a foreign corporate structure (and, of course, the Bahamas trusts). The uses to which that foreign corporate structure was put will be described hereinafter.
One motivation for deciding on a foreign corporate structure was desire to accumulate capital offshore, with minimum diminution by taxes and other costs, as a first step in Photocircuits' further exploitation of foreign markets for printed circuits. Photocircuits' long-range goals in

1960 included establishment of a research and development laboratory overseas, possible entry into foreign manufacturing (either directly or through acquisition of an equity interest in a foreign manufacturer), or both. There were, however, other reasons for the decision: insulation of Photocircuits from harassment in connection with patent litigation; facilitation of the licensing of new technology to Photocircuits' domestic competitors; and a favorable managerial and motivational climate for Dr. Egerer should his full-time services subsequently be desired.

In implementation of this decision, Day Company, N.V. ("Day") and Electric Techniques Corporation, N.V. ("ETCO") corporations organized and existing under the laws of the Netherlands Antilles and located in Curacao, were duly established in early 1961. 7 Curacao was selected as the location of the corporations because of its tax laws, political stability, proximity to the United States, and the flexibility it offered.

The sole director of both Day and ETCO was S. W. van der Meer, a Curacao attorney. Mr. van der Meer, who was a director of numerous corporations, was requested to take on the responsibilities of director of both corporations by a member of the law firm for Chemco and Photocircuits. After a complicated series of transactions described in finding 39, the common and preferred stock of both Day and ETCO came to be held by the Bahamas trusts. All of the trusts except those for the benefit of Mr. Burr held stock in both Day and ETCO. The trusts for the benefit of Mr. Burr acquired only stock in ETCO.

Neither Day nor ETCO had a manufacturing plant, laboratory, equipment, or office separate from that used by Mr. van der Meer as his law office. Mr. van der Meer had no technical training in electronics or related areas, and he spent minimal time on the activities of Day and ETCO. In the several transactions subsequently to be described, most, if not all, of Mr. van der Meer's activities were performed in implementation of written statements from the attorneys for Photocircuits and Chemco.

Under Dutch law, Mr. van der Meer was responsible for the appointment of agents for Day and ETCO. On March 7, 1961, he appointed Dr. Egerer as agent of both Day and ETCO, outside the United States, with authorization to negotiate and execute on behalf of each corporation contracts and agreements concerning licensing of technology, know-how, and technical data concerning printed circuits and related fields. The documents by which Dr. Egerer was so appointed were prepared by Photocircuits' and Chemco's attorneys and forwarded to Mr. van der Meer for execution. Mr. van der Meer had never met Dr. Egerer and had no knowledge of his qualifications. Except for Mr. van der Meer, Dr. Egerer, and a patent attorney for ETCO, neither Day nor ETCO had any personnel, employees, or officers.

Late in 1962, pursuant to a plan developed by the attorneys for Photocircuits and Chemco, both Day and ETCO were liquidated because of certain changes in United States tax laws. The assets of the liquidated corporations were distributed to the Bahamas trusts heretofore described.

IV. The Transactions

(a.) The Printed Circuit Technology. On February 18, 1961, Day and Photocircuits entered into an agreement "made this 1st day of November, 1960", providing for the sale by Photocircuits to Day, at a purchase price of $170,000, of certain specified inventions and technology relating to printed circuits (including existing patent applications and any patents which might issue on such applications), future patent rights in any inventions in the field of printed circuits in certain specified foreign countries (not including Italy), and rights to royalties under Photocircuits' license agreements with Ruwel and l'Air Liquide. Photocircuits' responsibility to its licensees with respect to exchange of know-how was not sold or transferred by its said agreement with Day. While Photocircuits had not developed a commercially feasible method of making printed circuit boards through its new CC-4 process by the end of 1960, it had by then found some practical commercial applications for some of its new technology in employing the old, etched foil, method of making such boards. The inventions specified in the Photocircuits-Day agreement related to the CC-4 process, and included two inventions then being used at a significant level by Photocircuits in its business.The $170,000 purchase price, payable in installments, was determined by Photocircuits based on an appraisal by Mr. Swiggett of the value of the United States rights to be transferred to Day ($120,000), and by Dr. Egerer of the value of the foreign rights ($50,000) to be so transferred. Mr. van der Meer executed the Photocircuits-Day agreement in implementation of a statement from the attorneys for Photocircuits and Chemco, and then returned it to them.At the same time the Photocircuits-Day "sale" agreement was executed, Day and Photocircuits entered into a second agreement "made this 1st day of November 1960" providing that Day granted Photocircuits a non-exclusive license to make, use and sell in the United States printed circuit products embodying the same inventions and technology "sold" by Photocircuits to Day. The specified royalty rate (1 percent of net sales by Photocircuits of "said printed circuit products"), determined by Photocircuits, was approximately the rate Photocircuits was then paying to Technograph of America for a license of similar technology. Mr. van der Meer's participation in the "license" agreement was essentially the same as his participation in the agreement of "sale".In December 1962, the Day-Photocircuits license agreement was amended to provide for a 6-year license, with a lump-sum payment of $153,000 due at execution of the amendment. Mr. van der Meer executed, but did not negotiate the terms of, the amending agreement. Pursuant to the agreement as so amended, Photocircuits gave Day an interest-bearing promissory note payable from 1963-68 and claimed royalty deductions on its federal income tax returns as the said promissory note was paid. Day included the entire amount of the said note as income in 1962.It should be noted at this point that Dr. Egerer, acting on behalf of Photocircuits, Day, Technograph, and others, visited Ruwel and l'Air Liquide on occasion during 1961 and 1962. During this period, on behalf of various principals, he also discussed with large foreign printed circuit manufacturers the possibility of licensing agreements. Following an approach by Lares Apparecchiature Radioelettriche ("Lares"), of Milan, Italy, a license agreement, dated October 4, 1962, between Photocircuits and Technograph as licensors, and Lares as licensee, was entered into. 8 During 1961 and 1962, obligations to exchange know-how resulting from Photocircuits' foreign licensing program continued to be discharged by Photocircuits, Technograph, Ruwel, and others. The exchange was beneficial to Photocircuits, Day, and others. Photocircuits' expenses in continuing to discharge its obligations in this respect were paid from royalty income due from foreign licensees to Day, prior to distribution of the net proceeds to Day. In 1962, both Ruwel and l'Air Liquide knew, or should have known, of Day's existence.Pursuant to the Photocircuits-Day agreement of sale, Day (or its trustee-assignee, Peter Graham) paid to Photocircuits $170,000 in installments through 1965. On its federal income tax return for the year ended December 30, 1961, Photocircuits reported the $170,000 as gain from the sale of capital assets and elected to report the said "gain" using the installment method. The amount reported by Photocircuits for the year ended December 30, 1961, was $45,000. Pursuant to the Day-Photocircuits license agreement, Photocircuits paid or accrued to Day a total of $39,902.52 for the year ended December 30, 1961. Photocircuits deducted the said amount as a royalty expense on its federal income tax for the said year.The Commissioner of Internal Revenue refused to recognize the Photocircuits-Day agreement of sale, and decreased Photocircuits' income for the year ended December 30, 1961, by the amount of $45,000. The Commissioner also disallowed the claimed deduction of $39,902.52 for royalty expense. The Commissioner also determined that the said $39,902.52 was a dividend to Chemco for its fiscal year ended August 31, 1962, and included this amount, reduced by the dividends received deduction, in Chemco's income for the said fiscal year.Thus, the printed circuit technology sale and license agreements are relevant to Photocircuits' action, arising as it does from tax adjustments for the year ended December 30, 1961, and to Chemco's action with respect to its fiscal year ended August 31, 1962.

(b.) The CRC Technology. On February 18, 1961, CRC and ETCO entered into an agreement "made this 1st day of November, 1960", providing for the sale by CRC to ETCO, at a purchase price of $100,000, of certain inventions and patent applications, including crosspatch interconnection boards (subject to earlier license agreements between CRC and Photocircuits), and other inventions by CRC. The said agreement also provided for the sale by CRC to ETCO of CRC's license fee rights under a license agreement dated November 25, 1960, between CRC and Photocircuits. 9 The $100,000 purchase price, payable in installments, was based on an appraisal by Mr. Burr, CRC's managing partner. Mr. Burr, who was familiar with the technology, considered factors normally taken into account in making such a valuation, but considered only potential sales by Photocircuits, not the possibility of CRC's licensing the technology to others. Mr. van der Meer did not negotiate the agreement of sale, but he did execute it in implementation of a written statement from the attorneys for Photocircuits and Chemco, and then returned it to them.For the year 1961, CRC filed a federal partnership information return reporting the $100,000 purchase price as gain from the sale of capital assets. Mr. Burr elected to report his 10 percent partnership share by the installment method. Pursuant to the CRC-ETCO agreement of sale, ETCO's trustee-assignee, Peter Graham, paid to CRC in 1963 a total of $18,750. Payment of the $100,000 purchase price was completed in 1965.At the same time the CRC-ETCO agreement of sale was executed, ETCO and Photocircuits entered into an agreement "made as of the 1st day of November, 1960", providing for the license by Photocircuits of the inventions covered by the CRC-ETCO agreement of sale. At that time, Photocircuits had a license to at least one of those inventions directly from CRC. The royalty rate specified in the said ETCO-Photocircuits license agreement, determined by Photocircuits, was 2 percent of net sales of products. Mr. van der Meer did not negotiate the said agreement, but did execute it, under the same circumstances as he executed the CRC-ETCO agreement of sale.Under the ETCO-Photocircuits license agreement, ETCO was responsible for prosecuting patent applications on the inventions licensed by it to Photocircuits. Mr. van der Meer executed a power of attorney authorizing such prosecution by CRC's patent attorneys, and a patent on one invention was granted, in the name of CRC, in December 1961.In December 1962, the ETCO-Photocircuits license agreement was amended to provide for a 6-year license, with a lump-sum payment of $170,000 due at execution of the amendment. Mr. van der Meer executed, but did not negotiate the terms of, the amending agreement. Pursuant to the agreement as so amended, Photocircuits gave ETCO an interest-bearing promissory note payable from 1963-68 and claimed royalty deductions on its federal income tax returns as the said promissory note was paid. In 1963, Photocircuits paid to Peter Graham, trustee-assignee of ETCO, $27,327.52 on the said promissory note. ETCO included the entire amount of the said note as income in 1962.The Commissioner of Internal Revenue determined that Mr. Burr's 10 percent partnership share of the $18,750 paid to CRC by Peter Graham, trustee-assignee of ETCO, during 1963, was a dividend paid by Photocircuits to Mr. Burr, and in consequence included $1,875 in Mr. Burr's income for that year. The Commissioner also determined that Mr. Burr's 10 percent share of the total amount of $27,327.52 paid by Photocircuits to Peter Graham, trustee-assignee, was dividend income to Mr. Burr, and in consequence included $2,732.75 in Mr. Burr's income for

1963. Due to the resultant increase in Mr. Burr's gross income for 1963 his allowable medical expense deduction was decreased, and otherwise proper medical expense deductions claimed for that year were disallowed.On this record, the CRC-ETCO and ETCO-Photocircuits agreements of sale and license are relevant only to Mr. Burr's action.

(c.) The Lithium Battery Technology. In 1960, a lithium battery technology developed by two foreign inventors, Danuta Herbert and Juliusz Ulam ("Herbert and Ulam") was brought to the attention of Photocircuits and Mr. Burr by Herbert and Ulam's representative, Marc Wood International, Inc. The future of the technology was speculative, but its potential value if reduced to practice was enormous. In 1960, Photocircuits engaged in negotiations with Marc Wood with respect to obtaining rights to the technology. Mr. Burr was consulted by Photocircuits during these negotiations. Prior to ETCO's incorporation, two agreements were entered into "as of" October 1960 between Herbert and Ulam and ETCO. Mr. Maxwell signed at least one of these agreements as "Manager" of ETCO, and Mr. Burr attested it. Neither Mr. Maxwell nor Mr. Burr was at the time or subsequently [pg. 74-5219] a duly appointed agent or employee of ETCO. On November 3, 1960, Mr. Maxwell "accepted" a letter from Marc Wood addressed to ETCO, in Curacao, confirming a verbal agreement with respect to licensing of part of the lithium battery technology.On February 18, 1961, ETCO and Photocircuits entered into an agreement, made as of October 5, 1960, providing that ETCO granted to Photocircuits a non-exclusive license to use for 1 year in the United States lithium battery technology and know-how, and a non-exclusive license under United States patent applications and patents issued thereon. ETCO's articles of incorporation had then been executed but had not then been published in the official gazette. Mr. van der Meer executed, but did not negotiate the terms of, the ETCO-Photocircuits lithium battery technology agreement. He also executed a power of attorney for prosecution of patent applications relating to the lithium battery technology. Following February 18, 1961, Photocircuits continued to deal directly with Herbert and Ulam and Marc Wood. ETCO, through Dr. Egerer, subsequently negotiated a "Heads of Agreement" with Herbert and Ulam, finalized June 1, 1962, by an agreement of sale. Mr. van der Meer signed the said agreement of sale.Pursuant to the original ETCO-Photocircuits lithium battery technology agreement, Photocircuits paid or accrued to ETCO sums totaling $38,500 during the year ended December 30, 1961. Photocircuits deducted this amount as a royalty expense on its federal income tax return for the said year. The Commissioner of Internal Revenue disallowed the claimed deduction of $38,500 for royalty expense. The Commissioner also determined that the said $38,500 was a dividend to Chemco for its fiscal year ended August 31, 1962, and included this amount, reduced by the dividends received deduction, in Chemco's income for the said fiscal year.Thus, the Herbert and Ulam-ETCO and ETCO-Photocircuits lithium battery technology agreements are relevant to Photocircuits' action, arising as it does from tax adjustments for the year ended December 30, 1961, and to Chemco's action with respect to its fiscal year ended August 31, 1962.

(d.) The Powderless Etching Bath. One of the products Chemco sold in 1960 was a powderless etching bath. Dow Chemical Company held worldwide patents on the bath, and aggressively protected such patents. Under Dow's licensing system a photoengraver paid a royalty based on the square footage of metal etched. In 1959 or 1960, Mr. A. J. Powers, Chemco's vice president in charge of research and development, learned of a new powderless etching bath in the process of development by the Lemaire brothers, two Belgian photoengravers. Mr. Powers spoke with them about the new bath in 1960. Several problems were evident. The Lemaire brothers were involved in patent infringement litigation brought by Dow in Belgium, the formula for the new process had not been perfected, and the Lemaires were having difficulty in prosecuting their United States patent application. Moreover, Chemco had an existing relationship with Dow it did not want to jeopardize, particularly if the new process proved infeasible. Mr. Powers nonetheless attempted to establish a working relationship with the Lemaires. In 1961, Chemco's patent attorney endeavored to assist the Lemaires' United States patent attorney in drafting a revised United States patent application, and the Lemaires sent samples of their bath to Chemco's plant in Glen Cove for testing. Chemco's tests of the bath were unsatisfactory and attempts to perfect the formula brought the sulfate content of the bath close to the lower limit of that covered by Dow's patent, thereby casting doubt on the fundamental underlying principle of the bath. Notwithstanding, an agreement between Chemco and the Lemaire brothers was "made this 22nd day of June, 1962." 10 The said agreement was "signed, notarized and sealed" by Mr. Powers for Chemco on June 22, 1962, transmitted by him to the Lemaires as vice president of Chemco, and signed by the Lemaires August 6, 1962. Under it, Chemco received an exclusive license in the Western Hemisphere to make, use and sell the Lemaires' bath, and Chemco agreed (a) to pay to the Lemaires 333,333 Belgian francs (about $6,000), less amounts previously paid by Chemco to the Lemaires' United States patent attorney, (b) to pay to the Lemaires a royalty of $0.46 per United States gallon of diluted (and of $1.05 per United States gallon of undiluted) bath sold by Chemco in the Western Hemisphere, and (c) to ship to the Lemaires a used camera.Neither party was entirely satisfied with the said agreement, and, by letter agreement dated September 7, 1962, between Chemco and the Lemaires, it was amended (in conformity [pg. 74-5220]with the provisions of the January 1961 letter agreement of understanding between Chemco and the Lemaires) to include a provision for payment of an additional 666,667 Belgian francs to the Lemaires. In the September 7, 1962 agreement, moreover, the Lemaires consented to an assignment of the June 22, 1962 agreement, and any rights and liabilities under it, to Day.On November 30, 1962, Mr. van der Meer executed an agreement, "made as of this 22nd day of June, 1962" between the Lemaires and Day. The terms of this agreement, in substance identical to those in the June 1962 Chemco-Lemaires agreement as modified September 7, 1962, with the exception of the contracting parties, were negotiated by Mr. Powers and the Lemaires.By agreement dated December 13, 1962, between Day and Chemco, Chemco received a non-exclusive license of the technology covered by the Lemaires-Day agreement just described. Chemco agreed to pay to Day a lump-sum royalty of $52,000 for a 3-year period, plus a per gallon royalty on sales above 80,000 United States gallons during that period of $0.65 per United States gallon of diluted (and of $1.48 per United States gallon of undiluted) bath sold by Chemco. Mr. Powers determined the terms of this agreement. Mr. van der Meer signed it. Following November and December 1962, Chemco continued to deal directly with the Lemaires.During its fiscal year ended August 31, 1963, Chemco paid to Peter Graham, trustee-assignee of Day, $11,555.52 pursuant to the Day-Chemco agreement. Chemco deducted this amount as a royalty expense on its federal income tax return for the said year. The Commissioner of Internal Revenue disallowed the claimed deduction. The Lemaires-Day and Day-Chemco agreements are thus relevant only to Chemco's action with respect to its fiscal year ended August 31, 1963.

[2] V. Decision.

In essence, plaintiffs contend that each of the several entities and transactions here involved was "bona fide and viable for Federal tax purposes *** ." Focusing attention primarily on the forms of the relevant transactions and agreements in issue in the respective cases, each plaintiff views the tax collector's treatment of it (or him) as erroneous.

In broad terms, defendant contends, inter alia, that Day and ETCO "cannot be viewed as corporate entities separate from Photocircuits and Chemco *** ", and that "sales" to Day and ETCO, with "simultaneous licenses back", were shams, to be disregarded for federal income tax purposes; 11 that CRC was a mere "research and development" arm of Photocircuits, with the latter actual owner of CRC technology assertedly sold to ETCO and then licensed to Photocircuits, or alternatively, a partnership in which Photocircuits and Mr. Burr were partners, with, in either event, resultant income to Mr. Burr; and that certain payments by Photocircuits to Day and ETCO were in actuality "disguised" dividends to Chemco.

(a.) Day and ETCO. One major cornerstone of defendant's argument is the premise that Day and ETCO "should be disregarded for income tax purposes." On the facts proven and the law, that contention fails. In Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 [30 AFTR 1291] (1943) (footnotes omitted) the Supreme Court stated that The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. *** See also Harrison Property Management Co. v. United States, 201 Ct. Cl.-,-, 475 F.2d 623, 626 [31 AFTR 2d 73-946] (1973).Settled, too, is another principle, strikingly stated by Judge Learned Hand in dissent in Commissioner v. Newman, 159 F.2d 848, 850-51 [35 AFTR 857] (2d Cir. 1947): *** Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant. See also Commissioner v. Tower, 327 U.S. 280, 289 [34 AFTR 799] (1946), Gregory v. Helvering, 293 U.S. 465, 469 [14 AFTR 1191] (1935), and Chisholm v. Commissioner, 79 F.2d 14, 15 [16 AFTR 585] (2d Cir. 1935).The formation of Day and ETCO (and the creation of the Bahamas trusts) were undeniably motivated in part by the desire of Chemco and Photocircuits, and of Mr. Burr, to keep taxes as low as possible. That, however, [pg. 74-5221] is not in and of itself the determinative consideration. Chisholm v. Commissioner, supra; Polak's Frutal Works, Inc., 21 T.C. 953, 973-74 (1954). The general rule is that the formation of a corporation for business purposes, or its creation followed by the carrying on of business by the corporation, suffices to establish a separate taxable entity. Moline Properties, Inc. v. Commissioner, supra; Carver v. United States, 188 Ct.Cl. 202, 208, 412 F.2d 233, 236 [23 AFTR 2d 69-1701] (1969).The record establishes with clarity that Day was formed for valid business reasons. The division of Photocircuits' business functions (manufacturing and licensing) Day facilitated was a perfectly natural one. Buffalo Meter Co., 10 T.C. 83 (1948); Seminole Flavor Co., 4 T.C. 1215 (1945). And, subsequent to its formation, Day, through Dr. Egerer, carried out substantial business activities.If the reasons for ETCO's formation are somewhat more difficult to perceive, the proof nonetheless is that ETCO too carried out substantial business activities subsequent to its formation. Inter alia, ETCO entered into agreements with, and made payments to, Herbert and Ulam, whose lithium battery technology was of enormous potential if reduced to practice. Dr. Egerer, as ETCO's agent, endeavored to assist in perfection of the lithium battery technology, and authority to prosecute patent applications was issued to an attorney. As the findings reflect, there were other business activities as well.In this connection, defendant's arguments about what Photocircuits (for example) might have done, in lieu of what it in fact did, are wholly irrelevant. The test is actuality, not supposition. See Sam Siegel, 45 T.C. 566 (1966); Polak's Frutal Works, Inc., supra; Grenada Industries Inc., 17 T.C. 231 (1951), aff'd 202 F.2d 873 [43 AFTR 450] (5th Cir.

1953), cert. denied, 346 U.S. 819 (1953). Too, the factor of control, on which defendant places so much reliance, is of no real import. National Carbide Corp. v. Commissioner, 336 U.S. 422 [37 AFTR 834] (1949); Harrison Property Management Co. v. United States, supra. Defendant further emphasizes that Day and ETCO had no manufacturing or other facilities or equipment in Curacao, operating there out of Mr. van der Meer's office; that Mr. van der Meer was a lawyer, unskilled in electronics, photoengraving, and the like; that, Dr. Egerer and a patent attorney aside, neither corporation had any agents; and that Mr. van der Meer devoted minimal time to the activities of Day and ETCO. These arguments are devoid of merit. Harrison Property Management Co. v. United States, supra; Carver v. United States, supra; Love v. United States, 119 Ct.Cl. 384, 96 F.Supp. 919 [40 AFTR 546] (1951); cf. Higgins v. Smith, 308 U.S. 473 [23 AFTR 800] (1940); Gregory v. Helvering, supra.On this record, Day and ETCO cannot simply be ignored, as defendant would have it, but should be, and are, recognized as valid and separate taxable entities. Moline Properties, Inc. v. Commissioner, supra, 319 U.S. at 439; see also Tomlinson v. Miles, 316 F.2d 710 [11 AFTR 2d 1375] (5th Cir. 1963), cert. denied, 375 U.S. 828 (1963). Whether, given this result, certain transactions involving one or the other of them should nonetheless be disregarded is, of course, a different question, still to be considered and resolved. Ingle Coal Corp. v. United States, 131 Ct.Cl. 121, 127 F.Supp. 573 [47 AFTR 64], cert. denied, 350 U.S. 842 (1955).

(b.) Circuit Research Company ("CRC"). It is abundantly clear from the record that CRC was established in 1958 for sound business reasons, and that, during the period here relevant, it was, functioned as, and must here be recognized as, a viable and separate entity, not a mere R&D branch of Photocircuits, nor a partnership composed of Photocircuits and Mr. Burr. Buffalo Meter Co., supra; Seminole Flavor Co., supra. Defendant's contrary contentions fail on the facts, summarized in Section I c, supra. As with Day and ETCO, however, the effect of CRC's dealings, insofar as relevant here, remains to be decided.

(c.) The Transactions. For the purpose of the proper administration of federal taxing statutes, transactions between closely related entities (and it is beyond question that Chemco, Photocircuits, CRC, Day, and ETCO were closely, if indirectly, related) are subject to special scrutiny to determine their true purpose and effect, and to assure that substance and reality prevail over form and sham. D. J. Campbell Co. v. United States, 177 Ct.Cl. 987, 370 F.2d 336 [18 AFTR 2d 6133] (1966); Ingle Coal Corp. v. United States, supra. See also Juniper Investment Co. v. United States, 168 Ct.Cl. 160, 338 F.2d 356 [14 AFTR 2d 5893] (1964); Town of Fairhaven v. United States, 135 Ct.Cl. 782, 788, 142 F.Supp. 590, 593 [49 AFTR 1846] (1956).

While each case presenting the question whether the form employed for doing business or for carrying out a challenged tax event is unreal or a sham essentially turns on its surrounding facts and circumstances, the decided cases teach generally that whether a valid business purpose underlies the transaction in question, whether the parties themselves regard it as altering or establishing rights, and whether the terms of the agreement are consistent with the standards of an arms-length one, are appropriate factors for consideration. See Sayles Finishing Plants, Inc. v. United States, 185 Ct.Cl. 196, 399 F.2d 214 [22 AFTR 2d 5173] (1968); Northern Pac. Ry. v. United States, 180 Ct.Cl. 388, 378 F.2d 686 [19 AFTR 2d 1648] (1967); Ingle Coal Corp. v. United States, supra; Audano v. United States, 428 F.2d 251 [26 AFTR 2d 70-5266] (5th Cir. 1970); W. H. Armston Co. v. Commissioner, 188 F.2d 531 [40 AFTR 460] (5th Cir. 1951); Egbert J. Miles, 41 T.C. 165 (1963); Roy J. Champayne, 26 T.C. 634 (1956).

(1.) The Printed Circuit Technology. The first transactions to be considered are the Photocircuits-Day "sale" and the Day-Photocircuits "license" of printed circuit technology. In form, the said documents reflect a sale of certain rights for $170,000, with a concomitant lease-back of certain of those rights, with royalties to be paid therefor depending on sales of printed circuit products embodying the licensed technology. That the two transactions were part of a single preplanned transaction is clearly not determinative in and of itself. Brown v. Commissioner, 180 F.2d 926 [39 AFTR 155] (3d Cir. 1950), cert. denied, 340 U.S. 814 (1950); Skemp v. Commissioner, 168 F.2d 598 [36 AFTR 1089] (7th Cir. 1948).Tax considerations aside, the agreement of sale was plainly sufficient to convey to Day legal title to the assets enumerated therein, and the license agreement was equally sufficient to grant to Photocircuits a license of technology. See John T. Potter, 27 T.C. 200 (1956); 35 U.S.C. §261 (1970). Despite defendant's reliance on asserted delay in formal "assignment", or recordation, that factor is devoid of any present significance. Ibid. The crucial considerations here are whether there was a valid business purpose for the transactions, whether the parties treated the transactions in conformity with rights and duties established by the formal documentation thereof, and whether they survive close scrutiny in terms of reasonableness. If so, substance and form coincide. The burden a taxpayer bears in challenging determinations of the Commissioner (see Lewis v. Reynolds, 284 U.S. 281 [10 AFTR 773] (1932)), has satisfactorily been met with respect to the Photocircuits-Day sale and the Day-Photocircuits license.As heretofore indicated, in terms of Photocircuits' printed circuit technology, valid business reasons existed for the creation of Day, and those same valid reasons justified the transfer of that technology to Day, for, without that transfer, those reasons could not be effectuated. And, following that transfer, and the concomitant license by Day, the proof is that both Day and Photocircuits conformed their actions to the terms of the respective agreements.Day appointed Dr. Egerer as its agent in 1961, and thereafter on occasion, acting for both Day and Photocircuits (as well as for others), he visited foreign licensees. During 1961 and 1962, he also discussed with other large foreign printed circuit manufacturers the possibility of licensing agreements. As Day's agent, Dr. Egerer also handled the prosecution of patent applications, and the assignment of inventions, in foreign patent offices where such activities were necessary. Day bore the cost of prosecution of patent applications in the United States. Both Ruwel and l'Air Liquide, with whom Photocircuits had entered into licensing agreements in 1958 and 1959, were or should have been aware of the subsequent existence of Day. Ruwel in fact became party to an agreement with Day in 1962.Defendant contends, however, that Photocircuits' control and dominion over the technology sold to Day was unimpaired by the sale. It asserts that Photocircuits in fact licensed that same technology to Lares October 4, 1962. If well-founded, defendant's assertion would, of course, weigh heavily against Photocircuits here. While Photocircuits' reply that it sold no Italian patent applications to Day is untenable, the inference defendant draws is simply not justified by the available evidence. In this same connection, Photocircuits had formally assigned to Day certain patent applications (and one patent) relating to the technology sold to Day just 3 days prior to the agreement between Technograph and Photocircuits as licensors, and Lares as licensee, on October 4, 1962. There is no mention in the Lares agreement of a purported transfer of any rights previously sold to Day. It cannot fairly be presumed that Photocircuits would then agree to receive in its own right royalty payments for the use of technology sold to Day in 1961, particularly where, had the technology licensed to Lares included that sold to Day, a different course would obviously have been far more satisfactory to Photocircuits from a tax standpoint. Defendant further contends that no "independent" appraisal of the technology sold to Day was obtained, that the purchase price and the royalty rate were "unilaterally" determined by Photocircuits, that Photocircuits purportedly sold for a mere $170,000 technology which from 1957-62 produced sales of printed circuit products of from $2,600,000 to $4,000,000 a year, and that, in consequence, the transactions are pure sham. These arguments are entirely unpersuasive. See Roy J. Champayne, supra. The implication that Photocircuits' 1957-62 sales were entirely, or even largely, attributable to the technology sold to Day is specious. That aside, however, the purchase price for that technology was determined on the basis of appraisals by Dr. Egerer and Mr. Swiggett, each of whom was eminently qualified for the task he performed, and the royalty rate specified in the license agreement approximated closely that paid to Technograph for a license of similar technology. In view of the highly competitive nature of the printed circuit industry in 1960, and the dangers inherent in exposure of such technology to an outsider for purposes of valuation, Photocircuits cannot fairly be faulted for following the course it did. The considerations which went into the determination of the purchase price, stated in the findings, were carefully reasoned, comprehensive and sound. Mr. Swiggett and Dr. Egerer testified at length at trial. Neither the fairness and reasonableness of their collective valuation opinion nor the fairness and reasonableness of the royalty rate can be doubted, on the record. In all the circumstances, the proof presented convinces that while the agreements of sale and license were not "arms-length" transactions in the normal sense of that term, they are nonetheless not to be disregarded for tax purposes by reason of any lack of fairness or reasonableness when judged by standards of a transaction entered into by parties thus dealing with each other. Defendant makes still further arguments in support of its plea of sham: among other things, it alludes to the activities of counsel for Photocircuits and Chemco in connection with the transactions; the minimal activities and knowledge of Mr. van der Meer, Day's sole director; and the net tax effect of the sale and license. All of defendant's arguments have received careful consideration, but they do not justify disregarding, for tax purposes, bona fide transactions between viable corporate entities.It is therefore concluded that the Commissioner erred (a) in decreasing Photocircuits' income, for its fiscal year ended December 30, 1961, by $45,000, by refusing to recognize gain from the sale of capital assets, and (b) in disallowing to Photocircuits, for its said fiscal year, royalty payments to Day pursuant to the Day-Photocircuits license. It follows therefrom that the Commissioner also erred in characterizing royalty payments to a separate taxable entity as dividends to Chemco during its fiscal year ended August 31, 1962.There is, however, a further issue with respect to the sale and license of printed circuit technology. Defendant contends that, even assuming a "bona fide sale was consummated between Photocircuits and Day, [the court] should, nevertheless, hold that the $36,422.35 in royalty payments which Day received from Photocircuits' European licensees in 1962 was taxable to Photocircuits because Photocircuits performed all of the services to which the income was attributable." 12 (Emphasis supplied.) As made, this argument is unrelated to Photocircuits' taxable year ended December 30, 1961, and its taxable year ended December 29, 1962, is not in issue in this court. Photocircuits first asserts that defendant has thus belatedly raised "a new issue or set-off", and that defendant should not now be permitted to do so. The fact is that defendant's stated contention is not pleaded, but it was in essence clearly raised in pretrial proceedings before the commissioner. With respect to Day's 1962 income, defendant's contention must be rejected. Even had this argument properly been raised, there is no competent evidence from which a finding as to Day's 1962 income from foreign licensees might be made. See Missouri Pac. R.R. v. United States, 168 Ct. Cl. 86, 338 F.2d 668 [14 Aftr 2d 5948] (1964).Nor can a finding be made as to Day's 1961 income from foreign licensees, although it is clear from the findings made that there was some such income in 1961. The substance of defendant's argument may therefore be intended to relate to Photocircuits' fiscal year ended December 30, 1961, and as to that taxable year the pleading and proof requirements differ from those applicable to defendant's present contention as made. Missouri Pac. R.R. v. United States, supra.The valid transfer of an income-producing asset is accompanied by the transfer of the right to receive the income generated by that asset. Blair v. Commissioner, 300 U.S. 5 [18 AFTR 1132] (1937); John T. Potter, supra. To the extent, therefore, that Day's 1961 income was attributable to the use of technology Day then owned, such income is plainly not taxable to Photocircuits. The problem is that some portion of Day's 1961 income may have been attributable to Photocircuits' persisting obligation to transmit know-how to the foreign licensees of the technology sold to Day. 13 And, it should be borne in mind, Photocircuits had a continuing right to receive know-how from those foreign licensees. For understandable reasons, the evidence, and the arguments of counsel, in these complex and difficult cases do not really focus on this narrow, subsidiary, issue. Further proceedings with respect to the amount of Photocircuits' recovery are in any event required by the conclusions expressed hereinabove. The interests of justice dictate that, absent agreement of the parties as to the effect, if any, of the continuing know-how exchange on Photocircuits' tax liability during its fiscal year ended December 30, 1961, that issue should not be decided on an inadequate record and imprecise arguments, but rather should be fully explored and resolved in such further proceedings.

(2.) The Lithium Battery Technology. Next to be considered are the Herbert and Ulam-ETCO and the ETCO-Photocircuits transactions relating to lithium battery technology. The Herbert and Ulam-ETCO agreements were executed "as of" October 1960. Mr. Maxwell, Photocircuits' president, signed at least one of them on behalf of ETCO, and he also "accepted" another agreement in November 1960. At both points in time, the formation of ETCO as a Curacao corporation had not been accomplished. In February 1961, ETCO "licensed" to Photocircuits lithium battery technology and know-how. Mr. van der Meer, ETCO's sole director, signed the latter agreement. Defendant does not urge that Herbert and Ulam were in any way related to Photocircuits. The government's position with respect to these transactions rests primarily on Photocircuits' undoubted opportunity to acquire the lithium battery technology in its own name, Mr. Maxwell's execution of documents in ETCO's name, and Photocircuits' dealings with the inventors in 1961 and 1962.There is no contention that Dutch corporate law precludes ratification of preincorporation agreements. Mr. Van der Meer specialized in international and corporate law, and was charged by Dutch law with management of ETCO's corporate affairs. In the premises, his 1961 execution of a license to Photocircuits of the Herbert and Ulam technology effectively refutes defendant's arguments based on Mr. Maxwell's signature on the Herbert and Ulam agreements. Mr. van der Meer would scarcely have licensed technology ETCO did not in his view own. ETCO's obligations to Herbert and Ulam preceded, and were wholly independent of, the ETCO-Photocircuits license agreement. Those obligations were clearly undertaken at arms-length. ETCO in fact made payments to Herbert and Ulam pursuant to its agreements with them. ETCO assumed responsibility for prosecuting patent applications relating to the lithium battery technology, and Mr. van der Meer executed a power of attorney for such prosecution. And ETCO licensed technology to Photocircuits.Dr. Egerer, ETCO's agent, corresponded with Herbert and Ulam, in an effort to assist in perfection of the technology. In 1961, ETCO, through Dr. Egerer, entered into a new agreement with Herbert and Ulam, superseding the 1960 agreements between these parties, and payments were made to the inventors pursuant to the new agreement. In short, as noted heretofore, ETCO carried on substantial business activities in connection with the lithium battery technology.On analysis, the real, if unstated, ground for defendant's challenge to these transactions is that Photocircuits could have entered into direct arrangements with Herbert and Ulam. Thus, it concludes, Photocircuits should be treated for tax purposes as if it had done so. Plainly, however, ETCO could, and did, enter into, and carry out, valid agreements with the inventors. And, it certainly could, at least, validly license United States rights in the technology it thereby controlled to Photocircuits, a related entity.There is no indication that any party to the lithium battery transactions deemed them merely formal. Photocircuits' dealings with Herbert and Ulam after the ETCO-

Photocircuits license in no way detract from the substance and reality of the transactions under consideration. Photocircuits' sole right to use the technology stemmed from its license from ETCO. A licensee of technology, and particularly of speculative technology of great potential value, is precluded neither by reason nor logic from communicating with the inventors of that technology, and the findings reflect neither derogation of ETCO's rights under its agreements with the inventors nor other justification for disregarding the transactions for tax purposes.The economic reality of the ETCO-Herbert and Ulam agreements is unquestionable. And, particularly considered in light of ETCO's unconditional obligations to the inventors, the terms of the ETCO-Photocircuits agreement are fair and reasonable. Indeed, defendant makes no suggestion to the contrary. Its position is, rather, only that Photocircuits, not ETCO, was Herbert and Ulam's "primary licensee". On this record, however, the transactions were in substance just what they were in form: an acquisition of rights by ETCO, and a subsequent license of a portion of those rights by it to Photocircuits. Payments by Photocircuits to ETCO pursuant to that license were ordinary and necessary business expenses in any normal sense of those words.In light of the foregoing, the Commissioner erred in (a) disallowing to Photocircuits, in its fiscal year ended December 30, [pg. 74-5225]1961, the amounts it paid or accrued to ETCO pursuant to the ETCO-Photocircuits lithium battery technology agreement, and (b) treating royalty payments to a separate taxable entity as dividends to Chemco during its fiscal year ended August 31, 1962.

(3.) The Powderless Etching Bath. As noted, there were several agreements respecting the powderless etching bath. The first was a letter agreement of understanding, in January 1961, between the Lemaire brothers and Chemco. The second was a mid-1962 license agreement between Chemco and the Lemaires. The third was a September 1962 agreement between Chemco and the Lemaires, reflecting the latter's consent to assignment of the said agreement, and any rights and liabilities under it, to Day. The fourth was a license agreement, made retroactive to June 22, 1962, between the Lemaires and Day. The fifth, and last, was a sublicense from Day to Chemco of the Lemaires' technology. What emerges from scrutiny of this series of transactions is that Chemco entered into a license agreement with the Lemaires, at specified royalty rates, in mid-1962. Day had then been in existence for over a year, and the Chemco-Lemaires relationship had then existed for at least that long. The Chemco-Lemaires agreement was "signed, notarized and sealed" by Mr. A. J. Powers for Chemco. Following the last agreement described above, however, Chemco had no more rights than it had had in mid-1962, but was obligated to pay to Day considerably more for a sublicense than it would have had to pay the Lemaires for a license under the Chemco-Lemaires agreements. Since the Day-Lemaires agreement contained the same terms as the Chemco-Lemaires agreement (as amended), Chemco thus clearly dealt with Day, a related entity, on preferential terms. Chemco urges that there was no license agreement between it and the Lemaires, but only a license agreement between the Lemaires and Day. The facts speak eloquently to the contrary. In substance, Chemco obtained a license from the Lemaires, subsequently obtained the Lemaires' consent to its assignment to Day, caused an agreement between the Lemaires and Day to be executed, and then sublicensed from Day, at higher prices, the Lemaires' technology. Payments by Chemco to Day (or, more precisely here, to Peter Graham, Day's trustee-assignee), pursuant to such facts and circumstances are plainly not ordinary and necessary business expenses, and the Commissioner did not err in disallowing such payments for Chemco's fiscal year ended August 31, 1963.In the latter connection, it is worthy of note that the Lemaires-Chemco agreement, as amended, reflected terms set in January 1961. Subsequent events not only had not enhanced the value of the Lemaires' technology, however, but in fact had cast doubt on the fundamental underlying principle of the Lemaires' bath. Thus, it is even more difficult to explain, much less justify as having any substance, the course of events which took place.

(4.) The CRC Technology. Finally, to be considered are the CRC-ETCO agreement of "sale" of technology, and the simultaneous ETCO-Photocircuits "license" of that same technology, as those agreements are relevant to Mr. Burr's federal income tax liability for 1963. As noted, Photocircuits had, in 1960, "first opportunity" to license from CRC, at a reasonable fee, any technology CRC might develop, and had in fact licensed from CRC technology relating to crosspatch interconnection boards and printed motors. As of November 1, 1960, the prescribed royalty rates were 10 percent for the crosspatch interconnection board technology and 6 percent (effective October 19, 1960, in lieu of the originally specified 10 percent) for printed motor technology.

To November 1960, CRC could license any of its technology Photocircuits had licensed to any third party, in or outside of the United States, only with Photocircuits' prior approval. By agreement dated November 25, 1960, however, Photocircuits in effect gave CRC the right to license such technology to third parties outside the United States without Photocircuits' prior approval. At the same time, the royalty rates to be paid to CRC by Photocircuits for both the printed motor and the crosspatch interconnection board technology were lowered to 2 percent. On February 18, 1961, two agreements, both made as of November 1, 1960, were executed. One was a "sale" by CRC to ETCO, at a "purchase price" of $100,000, of several CRC inventions, and of CRC's right to license fees under an agreement dated November 25, 1960, between CRC and Photocircuits. The second was a "license" by ETCO to Photocircuits of the same technology "sold" by CRC to ETCO, at a "license fee" of 2 percent of net sales of products embodying the "licensed" technology.

The $100,000 "purchase price" was based on an appraisal by Mr. Burr. In making the said appraisal, Mr. Burr (who had had some limited experience in valuing such technology) gave no consideration to the possibility that CRC might license the technology to anyone but Photocircuits. The "license fee" [pg. 74-5226] to be paid by Photocircuits to ETCO was unilaterally determined by Photocircuits.

In December 1962, the ETCO-Photocircuits "license" agreement was amended by restricting its duration to 6 years, and by substituting a lump-sum royalty of $170,000 (payable concurrently with the execution of the amendment) for the percentage royalty payments originally called for. Both 10 percent of the amount paid to CRC in 1963 by Peter Graham, ETCO's trustee-assignee, and 10 percent of the amount paid by Photocircuits to Mr. Graham in 1963 have been held by the Commissioner to be "dividend" income to Mr. Burr during 1963. Mr. Burr was not, during or prior to 1963, a shareholder in either Photocircuits or Chemco.

The form of the CRC-ETCO agreement of "sale" was legally sufficient to affect a transfer of technology from the former to the latter. CRC was not a mere research and development arm of Photocircuits, nor was it a partnership composed of Mr. Burr and Photocircuits. It was a separate entity, with technology of its own, and (absent factors not here present) it had a right to sell that technology if it chose to do so. Following the "sale", ETCO executed a power of attorney authorizing the prosecution of patent applications by CRC's patent attorney, and payments in recognition of the form of the "sale" were made by ETCO's trustee-assignee during 1963.
On careful analysis, however, the agreement of "sale" does not withstand the close scrutiny to which it is necessarily subject in determining whether the form and substance of the transaction coincide.

While that agreement ostensibly transferred to ETCO all of CRC's rights in the specified technology (as well as the right to income from Photocircuits), it is apparent that in reality only the right to license that technology to Photocircuits, and to receive income therefor, were to be so transferred. There is no suggestion on Mr. Burr's behalf that further exploitation of that technology, in the United States or outside it, was contemplated at the time of "sale", or thereafter. Indeed, Mr. Burr's valuation did not even consider the value of CRC's right to license the technology to others.

The foreign licensing rationale evident in the Photocircuits-Day transactions does not extend to this one, particularly where there is no showing whatever of an intent so to utilize the CRC technology. And even were there such a showing, the "sale" of CRC's right to income from Photocircuits is wholly unexplained. Possible tax benefits aside, no real reason for the "sale" is proffered or appears. That ETCO was a "counterpart" of Day, as all plaintiffs avow, is not, in and of itself, justification for the sale.

In sum, Mr. Burr has failed to establish that the purported "sale" of CRC's technology (and its right to income from Photocircuits) was, at least for tax purposes, real as distinguished from sham, or motivated by anything but tax avoidance.

Accordingly, the Commissioner's determination that Mr. Burr's 10 percent share of the amount paid to CRC by ETCO's trustee-assignee during 1963 was ordinary income, and not gain from the sale of capital assets, cannot here be faulted. See Audano v. United States, supra.

The Commissioner also held that 10 percent of the sums paid by Photocircuits to ETCO's trustee-assignee during 1963 under the 1961 "license", as amended in 1962, also constituted income to Mr. Burr. CRC, not Photocircuits, owned the technology to which these amounts related. Mr. Burr's reply brief suggests that this amounts to a "doubling of income by including the same amounts in [Mr. Burr's] income once in the form of the purchase price and once in the form of royalties."

To date, plaintiffs, and defendant, have urged wide-ranging, and not always consistent, theories embracing a multitude of complexities. E.g., Mr. Burr asserts the viability of both CRC and ETCO, and the validity for income tax purposes of the transactions between CRC, ETCO, and Photocircuits. On the other hand, defendant has advanced a host of alternative contentions as to those entities and the transactions, of sharply differing degrees of substance when measured in light of the record and the law.

In this state of events, it is reasonable to conclude that there are at least potentially a considerable number of difficult, intricate, and, because dependent upon the manner of resolution of other issues, essentially unbriefed questions relating to Mr. Burr's proper income tax liability for 1963. 14

In all the circumstances, the interests of justice dictate that such issues, for understandable reasons at best only adumbrated thus far, not be resolved at this time. The sound course, rather, is to defer their consideration to afford the parties an opportunity fully to identify and brief them, with some assurance of the factual background against which they will ultimately be evaluated. It may well be, of course, that in light of what has been stated hereinabove, the parties will be able to come to an agreement as to Mr. Burr's precise income tax liability for 1963. If not, however, all issues affecting that liability not resolved hereinabove should be reserved for further proceedings.

1 In Photocircuits Corporation, No. 28-69, and in Powers Chemco, Inc., No. 62-69, some tax adjustments have been settled by agreement. See findings 69(b), 73(d).

2 Trial was duly limited to the issues of law and fact relating to the right to recover.

3 Chemco's claim of right to recover for the year ended August 31, 1961, is no longer in issue.

4 Photocircuits' action, involving the taxable years ended January 2, 1959, and January 1, 1960, arises from tax adjustments for the year ended December 30, 1961. Findings 68-71.

5 Mr. Burr's action involves the year 1963. Mrs. Burr is a party solely by virtue of having filed a joint income tax return with her husband for 1963.

6 On January 1, 1960, Ruwel, with Photocircuits' consent, granted a sublicense to a Danish manufacturer and a Swedish manufacturer. Photocircuits also entered into agreements with the sublicensees at that time. Ruwel was obligated to transmit know-how to the sublicensees, but Photocircuits agreed to assume the responsibility in the event of Ruwel's inability to discharge this duty due to "force majeure."

7 Initial steps toward their formation took place in November 1960.

8 On October 1, 1962, Photocircuits formally assigned to Day certain patent applications relating to the technology specified in the Photocircuits-Day agreement of sale. One patent, issued in the name of Photocircuits in the interim, was included in the assignment.

9 In 1959, Photocircuits licensed from CRC crosspatch interconnection board and printed motor technology, at a royalty rate of 10 percent of net sales of products using the said technology. In October 1960, the printed motor technology royalty rate was reduced to 6 percent, and on November 25, 1960, the royalty rate on both the printed motor and crosspatch interconnection board technology was reduced to 2 percent.

10 In January 1961, Chemco and the Lemaire brothers had entered into a letter agreement of understanding stating certain points which both parties indicated would serve as a basis for a future contract.

11 This same argument also extends to "sales" by Herbert and Ulam to ETCO, with a "license" to Photocircuits, and by the Lemaires to Day, with a "license" to Chemco.

12 Defendant's Brief in Photocircuits Corporation, pp. 31-32.

13 Photocircuits' expenses in continuing to do so were in effect borne by Day.

14 Too, other partners in CRC, and Photocircuits, may well be affected here or elsewhere by this court's decision in Mr. Burr's case.