Cooper v. Commissioner: Give the Inventor a (Learned) Hand

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COOPER V. COMMISSIONER:
GIVE THE INVENTOR A (LEARNED) HAND

Rebecca R. Dulik

ABSTRACT
I. INTRODUCTION
II. BACKGROUND
A. Income Taxation: Ordinary vs. Capital
B. Section 1235
   1. History of § 1235 and Its Treatment in the 2017 Tax Bill
   2. Requirements of § 1235
C. Substance over Form Doctrine
III. THE CASES
A. Recent Substance over Form Decisions
   1. Summa Holdings & Benenson
   2. Mazzei
B. Section 1235 Cases
   1. Charlson v. United States
   2. Lee v. United States
C. Cooper v. Commissioner
   1. Facts and Procedural History
   2. The Opinions
IV. ANALYSIS
A. The Key Difference Between Cooper and Charlson/Lee
B. Consequences of the Cooper Decision
C. Suggestions
   1. Substance over Form Doctrine Should be Applied More Narrowly
   2. Congress Should Clearly Speak to Inventions and Capital Gains Treatment
V. CONCLUSION
COOPER V. COMMISSIONER: GIVE THE INVENTOR A (LEARNED) HAND

Rebecca R. Dulik*

ABSTRACT

Among the Internal Revenue Code’s many rules are some taxpayer-friendly provisions that grant tax benefits. Section 1235 is one such provision, providing to an inventor preferential tax treatment for income from the sale or exchange of a patent. In Cooper v. Commissioner, although the taxpayer inventor satisfied § 1235’s requirements, the Ninth Circuit affirmed the Tax Court’s decision to deny the taxpayer § 1235’s benefits. This Note compares Cooper to other § 1235 cases and argues that Cooper was decided wrongly because of the application of the substance over form doctrine. The substance over form doctrine is overapplied in general and, in light of the Code’s decades of development, may no longer be necessary. Additionally, because taxpayers require clarity in order to arrange their affairs, Congress should clarify the Code’s new internal inconsistency regarding the treatment of income from the sale or exchange of patents resulting from the Tax Cuts and Jobs Act.

I. INTRODUCTION

Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.

- Judge Learned Hand1

The Internal Revenue Code (“Code”) is a vast collection of rules written by Congress.2 It also contains legitimate methods for taxpayers to reduce, defer, or avoid certain types of taxes. As Judge Learned Hand famously said in 1935, a taxpayer who takes advantage of those Code provisions is not unpatriotic.3 Indeed, taxpayer-friendly rules are meant for taxpayers.

The Internal Revenue Service (“IRS,” “Service”) may disagree with a taxpayer’s

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3. Helvering, 69 F.2d at 810.
use of Code provisions, however. Multiple judicially-created tax-abuse doctrines allow the Service to cry foul on a taxpayer’s tax arrangements. While it is important for the government to be able to collect taxes owed, these doctrines can give the government an unfair advantage over taxpayers. In Cooper v. Commissioner, a taxpayer arranged his affairs to take advantage of a Code provision offering preferential tax treatment. Using the substance over form doctrine, the Service argued that, despite the taxpayer following § 1235’s requirements, he should be denied § 1235’s benefits. The Tax Court and the Ninth Circuit agreed.

Taxpayers in cases similar to Cooper’s won their cases. This Note argues that the key difference between Cooper and those cases was the application of the substance over form doctrine. This Note first offers some background in Part II on the tax treatment of ordinary and capital gains income, § 1235’s history and requirements, and the substance over form doctrine. It also touches on the 2017 Tax Bill (“Tax Cuts and Jobs Act”) and its implications for § 1235 moving forward. Part III briefly explores recent cases involving the substance over form doctrine and the two § 1235 cases referenced in Cooper, along with the facts of Cooper and the reasoning behind the majority and dissenting opinions. Part IV argues that Cooper was decided wrongly because the substance over form doctrine was erroneously applied, and that the doctrine should be applied more narrowly in the future, if at all. As Congress has continued to develop the Code since the inception of the substance over form doctrine, perhaps it is time to reevaluate the need for the doctrine. This Note’s conclusion asserts that taxpayers would benefit from more consistency and clarity so that they can adequately plan their affairs, and that, for the purposes of § 1235, that clarity is already found in the Code.

II. BACKGROUND

A. Income Taxation: Ordinary vs. Capital

The American system of taxation is based on income. Though some exceptions apply, a taxpayer is generally taxed when she realizes an “undeniable accession to wealth.” The taxable income is then characterized as either ordinary or capital. This distinction is at the heart of much litigation and this Note. Taxpayers generally prefer capital gains as they are taxed at preferential rates. If the Code offers capital gain income a special tax classification, it is often given preferential treatment. As of 2018, ordinary income is taxed at a top rate of 37%; capital gains are generally taxed at 0%, 15%, or 20% depending on the taxpayer’s ordinary income. Rev. Proc. 2018-18, 2018-10 I.R.B. 392 (2018).
Ordinary income includes income from wages, compensation for services, rents received, and business income whereas capital gains result from income from the sale or exchange of capital assets. Section 1221 of the Code defines capital assets as “property held by the taxpayer” but excludes property used in business (e.g. inventory, supplies, accounts receivable, property subject to depreciation) and self-created works. The 2017 Tax Cuts and Jobs Act recently amended the self-created works exception to specifically include patents. Section 1221 currently denies capital asset designation to “a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property” if the aforementioned item is held by “a taxpayer whose personal efforts created such property.”

In order to have a capital gain under general characterization principles, a taxpayer must have made an investment in the capital asset. Even though hard work is an investment of time and energy, hard work is not an investment in the eyes of the tax world. In other words, a taxpayer may not benefit from capital gains tax treatment for income resulting from her time and energy. Therefore, income generated from self-made goods and services is generally treated as ordinary. Section 1235 offers an exception to this rule for income from the sale or exchange of a patent.

B. Section 1235

Before discussing the mechanics of § 1235, it is worth taking a detour to Capitol Hill to explore the provision’s history, including implications for its future generated income.

9. Taxpayers are generally stuck with their choices, however. “[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not.” Comm’r v. Nat’l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974).


12. There is not enough room in this Note to discuss the bizarre treatment of musical compositions. “At the election of the taxpayer, paragraphs (1) and (3) of subsection (a) shall not apply to musical compositions or copyrights in musical works sold or exchanged by a taxpayer described in subsection (a)(3).” I.R.C. § 1221(b)(3) (2012).

13. I.R.C. § 1221(a)(3)(A) (Supp. 2018). Section 1221(a)(3)(B) provides that “in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced.” Section 1221(a)(3)(C) disallows capital asset designation if the item is held by the non-creator but the basis is the same in their hands.

14. Although an inventor may monetarily invest in her invention, that investment does not create the kind of investment necessary to achieve capital asset status. The Code may allow deductions under other provisions for these costs. See, e.g., I.R.C. §§ 162, 183, 212 (2012).

15. Congress’s intention to disallow capital gain treatment for self-created works is evidenced by its addition of § 1221(a)(3)’s denial of capital asset designation to artistic or literary creations after Dwight D. Eisenhower claimed capital gains for income from selling the rights to his book. See Calvin H. Johnson, Jeffrey H. Kahn & Douglas A. Kahn, Debate on Carried Interest, TAX NOTES, 1597, 1599 (Dec. 11, 2017).
by the recent Tax Cuts and Jobs Act.

1. History of § 1235 and Its Treatment in the 2017 Tax Bill

Although patents are self-created goods, they were not always excluded from the capital assets definition. In addition, for over half a century, § 1235 specifically allowed (and still allows) capital gain treatment for income from the sale or exchange of a patent. These two Code provisions worked together—§ 1221 implicitly defining patents as capital assets and § 1235 explicitly offering capital gains treatment on income from the sale or exchange of patents—to create a clear message that patents were an exception to the self-created goods rule and entitled to preferential tax treatment.

Before § 1235, income from the sale or exchange of a patent was only available to taxpayers whose transactions satisfied general capital asset requirements. To succeed, the patent had to be a capital asset. The IRS had considered patents of professional inventors inventory and therefore not eligible for capital asset status.16 When an amateur inventor sold his patent, even having satisfied all of the capital asset requirements, the IRS only allowed capital asset treatment for lump sum payments.17 Capital gain treatment originated from the realization that some income is “produced over a period of years but realized in a single tax year.”18 Capital gains rates lessen the taxpayer’s burden in those situations.19 Because royalty payments look like rent, the IRS treated them as ordinary income.20 The Tax Court first granted capital gain treatment to an amateur inventor in 1946 for royalty payments from the sale of a patent; the Commissioner did not acquiesce.21

Responding to the Service’s treatment of royalty payments, Congress added § 1235 in 1954.22 Patent sales situations are “so much like rental payments in the commonplace transactions involving other capital assets that Congress found it necessary to declare specifically that such transfers are entitled to capital gain treatment irrespective of the mode of payment.”23 As an “incentive to inventors to contribute to the welfare of the Nation,” Congress applied § 1235 equally to amateur and professional inventors.24 Section 1235 codified the sale or exchange requirement and additionally supplied the holding period required for a capital gain.25

Congress recently muddied the status of patents as an exception to the self-created goods rule. When the houses of Congress drafted their versions of the 2017 Tax Bill, the House proposed two changes involving patents. The House first

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17. See id.
18. Id.
19. Id.
20. This thought process can be illustrated in the real estate context: whereas the sale of land results in capital gain because land is a capital asset, income from rent collected on renting that same land is treated as ordinary income.
21. Fawick, 436 F.2d at 660.
23. See Fawick, 436 F.2d at 659.
25. Id. at 5082-83.
proposed to add patents to the capital asset exclusions of § 1221 and second, to eliminate § 1235 altogether.26 The Senate was silent on these two provisions. The final tax bill adopted the first change to § 1221 but failed to eliminate § 1235.27 Had both of the House’s suggestions been adopted, income from the sale of self-created patents would not be entitled to capital gains and this Note would be moot. What resulted instead is an internal inconsistency leaving confusion in its wake. “Thus, § 1221(a)(3) effectively provides that gain realized on the sale of a patent by its creator . . . is ordinary gain. At the same time . . . , § 1235 provides that such gain is long-term capital gain, so long as the seller sells all substantial rights to the patent. Both cannot be true.”28 Whether the inconsistency was an oversight29 or intentional, there is a now a cloud of uncertainty hanging over inventors.

Despite this apparent contradiction and the uncertainty of congressional intent, preferential rate treatment may still be available for inventor taxpayers under § 1235 even if § 1221 would deny it.

2. Requirements of § 1235

There are, of course, requirements to receive the benefits of § 1235. Capital gain treatment is available to “a holder” of a patent when “all substantial rights” are “transfer[red].”30 A “holder” of a patent can be the creator herself or “any other individual who has acquired his interest in such property in exchange for consideration” before the invention was reduced to practice, so long as that individual is not the creator’s employer or related to the creator.31

To address Congress’s concern about inventors controlling a holding corporation to which they transferred their patents, it specifically included a control element in § 1235. Section 1235(c) excludes a transfer of a patent to a “related person.”32 A “related person” for § 1235 purposes is either a family member or a corporation.33 Related family persons include only “spouse[s], ancestors, and lineal descendants.”34 The Treasury Regulations state that a related person “does not

27. Id.
29. After all, it was a quick process. See Thomas Kaplan & Alan Rappeport, Republican Tax Bill Passes Senate in 51-48 Vote, N.Y. TIMES, (Dec. 20, 2017), https://www.nytimes.com/2017/12/19/us/politics/tax-bill-vote-congress.html [https://perma.cc/7XMH-89FF] (“Republicans in Congress moved with remarkable speed in their bid to enact the biggest tax overhaul since 1986, unveiling legislation to rewrite the tax code, marshaling support for their effort and devising a compromise between the House and Senate in under two months.”).
31. I.R.C. § 1235(b)(1)-(2).
32. Id. § 1235(c).
33. Id. § 1235(c)(1)-(2). Section 1235(c) cross references to § 267(b) and § 707(b) with slight differences. Notably, a related family person is less restrictive under § 1235.
34. Id. § 1235(c)(2).
include a brother or sister.”

A corporation is a related person if the holder owns “25 percent or more” of the entity. This percentage was lowered from 50% in 1958. Congress thought that lowering the percentage to 25 would “prevent possible abuses arising . . . within essentially the same economic group.” Therefore, an inventor is not precluded from enjoying § 1235’s benefits if she owns less than 25% of the transferee holding corporation and her sister owns the rest.

Despite the clear line drawn by Congress in § 1235’s control requirement, the IRS has argued that some inventors have too close of a relationship with their transferee(s) to comfortably satisfy § 1235. Congress responded to its concern about an inventor’s ability to control a transferee holding corporation with § 1235(c), however, and § 1235(c) does not impose a control test based on the strength of the inventor’s relationships.

Lastly, a “key consideration” for whether § 1235 is satisfied is the transfer of “all substantial rights.” If less than all substantial rights are transferred, then any income to the transferor will likely be treated as ordinary. An inventor must transfer “all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent . . . are transferred.” The regulations offer guidance about what it means to retain substantial rights, including limiting the scope of the transfer by geography, field of use, or for a period of time less than the patent’s remaining life. While the regulations do state that retaining the right to terminate the agreement is a substantial right, the regulations do not focus on control under the “all substantial rights” element.

C. Substance over Form Doctrine

Even if a taxpayer follows the Code’s requirements, the Service may recharacterize a taxpayer’s income. The substance over form doctrine has its judicial

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36. I.R.C. § 1235(c)(1); see also Garfield v. Comm’r, 92 T.C.M. (CCH) 496 (T.C. 2006), aff’d, 290 F. App’x 392 (2d Cir. 2008).
39. This arrangement “is not considered as transferring such rights to a related person since the [sister] relationship is to be disregarded for purposes of section 1235.” Treas. Reg. § 1.1235-2(f)(3).
40. See infra Section III.B.
41. Cooper v. Comm’r, 877 F.3d 1086, 1091 (9th Cir. 2017) (citing I.R.C. § 1235(a)).
43. Treas. Reg. § 1.1235-2(b); see also Spireas, 112 T.C.M. (CCH) 262, at *23 (citing E.I. du Pont de Nemours & Co. v. United States, 432 F.2d 1052, 1055 (3d Cir. 1970)) (The inquiry is “whether [the taxpayer] has retained rights that, in the aggregate, have substantial value.”).
44. Treas. Reg. § 1.1235-2(b)(i)-(iii); see, e.g., Estate of Klein v. Comm’r, 507 F.2d 617, 620 (7th Cir. 1974); Kueneman v. Comm’r, 68 T.C. 609, 619 (1977); Spireas, 112 T.C.M. (CCH) 262, at *23-24.
45. Treas. Reg. § 1.1235-2(b)(4); Eickmeyer v. Comm’r, 580 F.2d 395 (10th Cir. 1978).
roots in *Gregory v. Helvering*, a 1935 Supreme Court case, though its concept dates back to at least the 1920s. In *Gregory*, a taxpayer satisfied the literal elements of a reorganization Code provision when she created a new corporation to which she transferred assets tax-free from her existing corporation, and then subsequently dissolved the new corporation, thereby distributing those assets to her. The short-lived corporation had no other business purpose. The Supreme Court acknowledged that the taxpayer had satisfied the elements of the provision, but asked “whether what was done, apart from the tax motive, was the thing which the statute intended.”

Although the Board of Tax Appeals found for Gregory because “[a] statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves the small interstices for judicial consideration,” the Supreme Court disagreed. Because it viewed Gregory’s use of the Code provision as “elaborate and devious” and outside of its congressionally-intended purpose, the Court denied her its benefits, declaring that “[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.”

The *Gregory* decision helped create “a welter of rules and extrastatutory standards” that courts apply to tax cases. Outside of substance over form cases, the Supreme Court has typically applied statutory language rather than judicially-created doctrines. Lower courts followed the Supreme Court’s non-textualist lead in tax cases. The substance over form doctrine and its fellow anti-abuse doctrines are confusing, often applied in combination, and applied inconsistently, but have

49. *Id.*
50. *Id.* at 469.
52. *Gregory*, 293 U.S. at 470.
53. *Id.*
54. Isenbergh, *supra* note 4, at 863; see also Boris I. Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 HOW. L.J. 693, 695 (1978) (The substance over form doctrine and other anti-abuse doctrines are part of “presuppositions or criteria that are so pervasive that, in combination, they resemble a preamble to the Code, describing the framework within which all statutory provisions are to function.”).
58. See Madison, *supra* note 55, at 722 (“The various courts of appeals have not agreed on which substance-over-form doctrines apply, how the doctrines apply, or when the doctrines apply.”). For a discussion of court decisions, see *id.* at 722-38.
become commonplace.59

Additionally, tax-abuse doctrines are typically employed by the government against taxpayers.60 While a taxpayer is generally stuck with the form she chooses, the government has the opportunity to convince a court that it should be allowed to recharacterize the taxpayer’s transaction.61 Ultimately, a court that engages in a substance over form analysis may not approach the case neutrally; the doctrine may serve as the conclusion.62 Had Gregory been decided differently, it would be “hard to imagine that any judge would feel licensed to follow a pure gut response in deciding a tax dispute.”63

The doctrine has its critics and has become a topic of debate in recent court decisions.64 Rather than “sav[ing] the world from manipulative taxpayers,” the application of the substance over form doctrine unnecessarily complicates tax law.65 Because Congress has the ability to amend the Code in response to unfavorable court decisions that result from its statute writing, “[t]he sort of ‘creative’ jurisprudence found in the cases on form and substance cannot, in the end, be justified by any demonstrable needs of sound tax administration.”66 In other words, it is Congress’s job to define the nature of Code provisions and draft requirements that clearly reflect that nature. Congress does not benefit from “judicial attempts to make the law ‘better’” in individuals’ tax cases.67 Indeed, hardly anyone does.68

III. THE CASES

This section highlights some recent substance over form decisions, the two § 1235 cases relied on in the Cooper arguments, and the Cooper decision itself.

59. See, e.g., In re CM Holdings, Inc., 301 F.3d 96, 102 (3d Cir. 2002) (explaining that “courts should not elevate form over substance by rewarding taxpayers who have engaged in transactions that lack any purpose save that of tax savings.”); Crenshaw v. United States, 450 F.2d 472, 477-78 (5th Cir. 1971) (denying taxpayers’ transaction preferential tax treatment when “such a result would completely thwart the Congressional policy to tax transactional realities.”); Tracinda Corp. v. Comm’r, 111 T.C. 315, 326 (1998) (As a general rule, the Tax Court employs the substance over form doctrine when “the substance of the transaction differs from its form,” but “[i]f substance follows form then [it] will respect the form chosen by the taxpayer.”).

60. See Schneider, supra note 56, at 39.

61. See Higgins v. Smith, 308 U.S. 473, 477 (1940) (“A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.”).


63. Isenbergh, supra note 4, at 882.

64. See infra Section III.A.

65. See Isenbergh, supra note 4, at 879; see also Linda D. Jellum, Codifying and “Miscodifying” Judicial Anti-Abuse Tax Doctrines, 33 VA. TAX REV. 579, 595 (2014) (referring to the substance over form doctrine as “amorphous.”).

66. Isenbergh, supra note 4, at 881.

67. Id.

68. Tax lawyers, of course, benefit from the added confusion. See id. at 883 (“The heavier the layers of judicial divination superimposed on the Internal Revenue Code, the richer tax lawyers are apt to get.”).
A. Recent Substance over Form Decisions

1. Summa Holdings & Benenson

In *Summa Holdings, Inc. v. Commissioner*, the Sixth Circuit reversed the Tax Court’s denial of relief to taxpayers who utilized complex Code provisions to lower their taxes.69 The purpose of the provisions at issue in *Summa* is, like many of the Code’s provisions, to lower taxes.70 Up front, the Sixth Circuit criticized the Commissioner’s reliance on the substance over form doctrine:

> Each word of the “substance-over-form doctrine,” at least as the Commissioner has used it here, should give pause. If the government can undo transactions that the terms of the Code expressly authorize, it’s fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. “Form” is “substance” when it comes to law. The words of law (its form) determine content (its substance). How odd, then, to permit the tax collector to reverse the sequence—to allow him to determine the substance of a law and to make it govern “over” the written form of the law—and to call it a “doctrine” no less.71

All parties in *Summa Holdings* acknowledged and agreed that the taxpayers followed the Code.72 “If this case dealt with any other title of the United States Code, we would stop there, end the suspense, and rule for [the taxpayers].”73 But, the Sixth Circuit continued, “when it comes to the Internal Revenue Code, the Commissioner claims a right to reclassify Code-compliant transactions under the ‘substance-over-form’ doctrine in order to respect ‘overarching . . . principles of federal taxation.’”74

The Sixth Circuit drew a crucial distinction in the doctrine between reclassifying transactions to reflect a taxpayer’s economic reality and reclassifying transactions in such a way that the statute is recharacterized.75 To be sure, the court acknowledged the need for the substance over form doctrine when it comes to squirrely taxpayer behavior like calling income something other than income to avoid paying taxes.76 However, the Sixth Circuit cautioned that the Code is the law and if the Service disagrees with the result when the Code is followed,77 the Service cannot unilaterally change the law; that is Congress’s job.78

69. *Summa Holdings, Inc. v. Comm'r*, 848 F.3d 779, 782 (6th Cir. 2017). The taxpayer utilized a DISC to increase Roth IRA accounts past individual contribution limits.
70. *Id.*
71. *Id.*
72. *Id.* at 784.
73. *Id.*
75. See *id.* at 785.
76. *Id.*
77. This sentiment assumes that the taxpayer followed the Code legitimately, not a “labeling-game sham or defied economic reality.” *Id.* at 786.
78. See *id.* at 790. The Sixth Circuit mused that “[p]erhaps the Commissioner’s approach made some sense decades ago, when the Code was simpler, and before Congress decided to pursue a wide range of policy goals through a complicated set of tax credits, deductions, and savings accounts.” *Id.* at 789.
The First Circuit decided *Benenson v. Commissioner* in April of 2018. The facts are similar to those in *Summa Holdings* but the parties are different. The First Circuit, therefore, made its own decision based on an “independent determination of the issues.” Like the Sixth Circuit, the First Circuit reversed the Tax Court and held for the taxpayer, concluding that “the transaction [did] not violate the plain intent of the relevant statutes.”

The First Circuit defined its approach to the substance over form doctrine in *Benenson* as a tool of statutory interpretation. The Code is a collection of statutes, and the doctrine “helps courts read tax statutes in a way that makes their technical language conform more precisely with Congressional intent.” The First Circuit, therefore, began its analysis by looking at the Code provisions implicated. From there, the court concluded that the taxpayers did something that the Code allows, and that if what the taxpayers did is not in line with what Congress intended, then it is up to Congress to fix it, not the courts.

2. Mazzei

After the Sixth Circuit decided *Summa Holdings*, and just before the First Circuit decided *Benenson*, the Tax Court decided *Mazzei v. Commissioner*. The Service argued the substance over form doctrine and the Tax Court agreed. The majority discussed the Sixth Circuit’s *Summa Holdings* opinion but said that its holding did not apply in Mazzei’s case because Mazzei merely labeled his transaction something that it was not, and therefore, the IRS was within its rights to argue substance over form.

The dissent disagreed. Judge Holmes considered the facts of *Mazzei* to be “nearly identical” to the facts in *Summa Holdings*, and argued that in light of the Sixth Circuit’s reversal of *Summa Holdings*, the Tax Court should have reconsidered its analysis. The dissent called out the approach used by the majority—“perhaps more common in tax law than in any other legal specialty”—as wrong because it “abandon[s] general principles of statutory construction in favor of using judge-made doctrines that undermine or ignore the text of the Code to recast transactions to avoid
The dissent agreed with the Sixth Circuit that the substance over form doctrine is correctly applied in situations where taxpayers attempt to get beneficial tax treatment by deviously calling something something that it is not, but did not think that the facts of Mazzei suggested devious actions. While agreeing that a dog-owner cannot benefit from a statute offering subsidies for cow-owners simply by calling his dog a cow, Judge Holmes asserted that “rich people buying cows they don’t otherwise need in order to get the cow subsidies isn’t the same thing.”

B. Section 1235 Cases

As previously discussed, if a taxpayer inventor retains substantial rights over a patent or transfers substantial rights to a related party, then he has not given away the patent and will be denied § 1235 benefits. The question presented is whether a taxpayer, despite satisfying the provision’s elements, including its control requirement, may be denied § 1235’s preferential tax benefits if the government argues that he controls the transferee corporation. There are only a handful of § 1235 cases that discuss control under the “all substantial rights” element. While the taxpayer in Cooper lost his case, the taxpayers in both Charlson v. United States and Lee v. United States were granted capital gains treatment under § 1235 despite similar issues of control.

1. Charlson v. United States

In Charlson, the Court of Claims was primarily concerned with whether Charlson effectively controlled the corporation to which he sold his patents when the corporation was composed of four of his friends and business associates, including his personal attorney, and the sole reason for the corporation’s creation was to purchase the taxpayer’s patents. Although the four individuals had “diverse business talents,” when the corporation decided to sell the patents a few years later, one of the primary reasons was because “[t]he patents had proved to be of great value and their successful exploitation was beyond [the corporation]’s fairly amateur capabilities.” Charlson was not a shareholder, but he advised the corporation, was “of aid” to his friends, and “explain[ed] the technical difficulties and advantages of [his inventions] to the prospective licensees.”

The Commissioner argued that Charlson’s royalty payments were ordinary

89. Id. at 81.
90. Id. at 82.
91. Id.
92. See supra Section II.B.2.
93. Perhaps this is because of § 1235’s separate control requirement.
95. Id. at 1049, 1051.
96. Id.
income because his friends’ corporation was either a sham corporation\textsuperscript{97} and/or it was controlled by Charlson.\textsuperscript{98} Charlson, on the other hand, argued that the corporation “conducted its own business to advance its own interests without outside intervention or interference.”\textsuperscript{99}

While the court determined that it was possible for a taxpayer to control a transferee corporation despite satisfying § 1235(c)’s specific control requirement, it held that Charlson did not control his friends’ corporation.\textsuperscript{100} The Court of Claims acknowledged that “it [was] . . . apparent that the choice of shareholders was greatly influenced by Mr. Charlson’s friendship . . . [and] that they would be less likely to do things adverse to his interests than a large unknown company would.”\textsuperscript{101}

Everyone involved in the corporation, including the shareholders, benefited from the “mutual advantage” of Charlson’s involvement in the corporation.\textsuperscript{102} Although his relationships with these four individuals “existed for many years” and “[t]hese circumstances made more probable, whether pursuant to some mutual understanding or not, the existence of retained control,” the court ultimately decided that “this probability [fell] far short of proof.”\textsuperscript{103}

2. Lee v. United States

The facts of Lee involve two coworkers on the night shift who designed a tool together.\textsuperscript{104} One of the men continued working at his job, the other, Lee, left to pursue the invention’s business as a sole proprietorship.\textsuperscript{105} The business was lucrative and Lee decided to incorporate to protect the business and sought to do so under § 1235 to reap its benefits.\textsuperscript{106} Lee transferred the patent to a new corporation composed of himself (24%) and his old coworker (76%).\textsuperscript{107} Lee was president of the new corporation and on the board of directors.\textsuperscript{108}

The government argued that Lee had not transferred “all substantial rights” because he was in control of the new corporation.\textsuperscript{109} The court interpreted the government’s argument as suggesting that any transfer to a closed corporation would destroy § 1235 treatment, but congressional intent does not support that position.\textsuperscript{110}

The court ultimately held that even though the men knew each other well over many

\begin{thebibliography}{11}
\bibitem{97} The sham doctrine is one of the anti-abuse doctrines often intermingled with substance over form. The government’s “sham corporation” argument in Charlson is beyond the scope of this Note. The court did not agree with it anyhow. \textit{id.} at 1057.
\bibitem{98} \textit{id.} at 1052.
\bibitem{99} \textit{id.}
\bibitem{100} \textit{id.} at 1055.
\bibitem{101} \textit{id.} at 1054-55.
\bibitem{102} \textit{id.} at 1055. An inventor’s expertise likely helps maintain and increase share value.
\bibitem{103} \textit{id.} at 1054.
\bibitem{104} Lee v. United States, 302 F. Supp. 945, 946 (E.D. Wis. 1969).
\bibitem{105} \textit{id.} at 947.
\bibitem{106} \textit{id.}
\bibitem{107} \textit{id.} at 948.
\bibitem{108} \textit{id.}
\bibitem{109} \textit{id.} at 950.
\bibitem{110} See \textit{id.}
\end{thebibliography}
years, Lee complied with the statute and “[t]here was no evidence presented which suggested Lee was otherwise [aside from his 24% vote] able to force the other stockholders or directors to do his bidding.”\footnote{111}

\section*{C. Cooper v. Commissioner}

\subsection*{1. Facts and Procedural History}

Cooper is an inventor.\footnote{112} He had an arrangement with a licensing company whereby he legitimately received capital gain treatment on royalties received from his patents, but the relationship went sour with a money dispute and subsequent litigation.\footnote{113} Cooper thus had to find another equally beneficial home for his patents. He sought an attorney’s advice before he, his wife, his wife’s sister (Walters), and a friend (Coulter) incorporated a new company with the purpose of purchasing and exploiting Cooper’s patents.\footnote{114} Cooper and his wife owned only 24% of the stock to stay within \S\ 1235’s requirements.\footnote{115} The Commissioner determined that Cooper’s royalties were ordinary income because he effectively controlled the corporation.\footnote{116}

The Tax Court and the Ninth Circuit agreed.\footnote{117} Because Walters and Coulter were the majority shareholders and directors of the corporation, the Tax Court analyzed their roles and actions in determining whether Cooper retained control of the corporation.\footnote{118} The Tax Court took into account the directors’ lack of “patent, engineering, or other such skills” in its decision that they were not “particularly valuable” while relegating to a footnote the women’s degrees in finance and economics, and accomplishments in professional fields, including Coulter’s ownership of a company.\footnote{119}

The Tax Court gave weight to Cooper’s previous failed business relationship as evidence that he chose shareholder directors whom he knew and purportedly could control.\footnote{120} Coulter and Walters testified that they relied on the expertise of Cooper, as well as the corporation’s attorneys and accountants.\footnote{121} After determining that Coulter and Walters did not act on their own, the Tax Court concluded that Cooper effectively controlled them and the corporation.\footnote{122}

\footnotesize

\begin{itemize}
  \item \footnote{111}{Id.}
  \item \footnote{112}{Cooper v. Comm’r, 877 F.3d 1086, 1088 (9th Cir. 2017).}
  \item \footnote{113}{Id. at 1088-89.}
  \item \footnote{114}{Id. at 1089.}
  \item \footnote{115}{Id.}
  \item \footnote{116}{Id.}
  \item \footnote{117}{Id. at 1091.}
  \item \footnote{118}{See Cooper v. Comm’r, 143 T.C. 194, 201-02 (2014).}
  \item \footnote{119}{Id. at 198 n.10, 211. There is no requirement in the Code that a transferee corporation’s directors have previous knowledge of patents. There is no requirement in the Code that a transferee corporation’s directors be men.}
  \item \footnote{120}{Id. at 211.}
  \item \footnote{121}{Id. at 212. Again, there is no requirement in the Code that a transferee corporation’s directors have previous knowledge of how best to run a patent corporation. To say otherwise would discourage newcomers to the endeavor.}
  \item \footnote{122}{Id. at 213.}
\end{itemize}
2. The Opinions

a. Majority

Early in its opinion, the Ninth Circuit invoked the substance over form doctrine as “[a] bedrock principle of tax law.”\textsuperscript{123} The court then expressly adopted the \textit{Charlson} court’s stance that “[i]f a patent holder exercises control over the recipient corporation such that, in effect, there has not been a transfer of all substantial rights in the subject patent(s), then the requirements of § 1235 are not met, even if the documents describing the transfer formally assign all substantial rights.”\textsuperscript{124}

Next, despite the fact that “mere influence” will not defeat § 1235, the Ninth Circuit concluded that “effective control” will defeat it because the taxpayer “did not effectively transfer all substantial rights to the patent(s).”\textsuperscript{125} The smoking gun for the majority was the corporation’s transfer of patents to Cooper for no consideration.\textsuperscript{126} Because “the right to retrieve ownership . . . is a substantial right,” the Ninth Circuit held that “the Tax Court did not clearly err in ruling that Mr. Cooper did not transfer ‘all substantial rights’ to the patents.”\textsuperscript{127}

The majority adopted the Tax Court’s findings that Walters and Coulter “exercised no independent judgment,” did not “act in their best interests as shareholders,” and that decisions about the patents were made by Cooper.\textsuperscript{128} In light of the fact that the corporation returned patents, the Tax Court’s findings supported the Ninth Circuit’s conclusion that “there is no reason to think that [Walters and Coulter] would have objected to the rescission of any other transfer of patents.”\textsuperscript{129}

b. Dissent

While the majority contended that the correct question was “whether . . . Mr. Cooper retained the ability to retrieve the patents at will,” the dissent suggested “that [the court] must ask whether, in theory, [the corporation] could have declined to transfer the patents back to Mr. Cooper.”\textsuperscript{130} Judge Kleinfeld’s dissent primarily disagreed with the majority’s definition of control. “The majority err[ed] . . . because it dilute[d] the meaning of ‘control’ from the ability to compel a result to something less and indeterminate.”\textsuperscript{131} By diluting the meaning of control, the majority’s opinion is “at odds” with the authority it cites, including the \textit{Charlson} decision and the Treasury Regulations on point.\textsuperscript{132}

\begin{itemize}
  \item \textsuperscript{123} Cooper v. Comm’r, 877 F.3d 1086, 1091 (9th Cir. 2017) (“[C]onsiderable legal authority supports [the court’s] conclusion that, when determining whether there has been a transfer of all substantial rights, we must look beyond the bare form of the transaction.”).
  \item \textsuperscript{124} \textit{Id.} at 1092.
  \item \textsuperscript{125} \textit{Id.}
  \item \textsuperscript{126} \textit{Id.} at 1093.
  \item \textsuperscript{127} \textit{Id.}
  \item \textsuperscript{128} \textit{Id.} at 1092-93.
  \item \textsuperscript{129} \textit{Id.} at 1093.
  \item \textsuperscript{130} \textit{Id.}
  \item \textsuperscript{131} \textit{Id.} at 1096 (Kleinfeld, J., dissenting).
  \item \textsuperscript{132} \textit{Id.}
\end{itemize}
In arguing that Cooper had less control over his patents’ transferee corporation than Charlson had, Judge Kleinfeld made the astute observation that in **Charlson**, the taxpayer had power over the four shareholders in the transferee corporation because they were his employees and one was his personal attorney.\(^{133}\) “As such, Charlson could fire each of them if he disliked how they voted,” and yet, Charlson won his case.\(^{134}\) While both Charlson and Cooper’s holding corporations looked to them for recommendations and guidance about their patents, the **Cooper** court viewed the arrangement as Cooper exercising control, whereas the **Charlson** court saw the arrangement as mutually beneficial to Charlson and the corporation’s shareholders. Because “influence is all Cooper had,” the dissent suggested that Cooper’s case is more similar to the **Lee** case.\(^{135}\) In **Lee**, control was defined as “whether the taxpayer can ‘force’ the transferee to do his bidding.”\(^{136}\) There is no evidence in the record that Cooper had such force.

### IV. Analysis

#### A. The Key Difference Between Cooper and Charlson/Lee

The facts of **Cooper** are similar to the facts in **Charlson** and **Lee** in many respects. First, the corporations to which all three inventors transferred their patents were created specifically for that purpose. An indication that the substance of a transaction does not match its form is when the transaction lacks a business purpose, thereby demonstrating that the taxpayer designed a transaction merely for tax avoidance. Holding corporations are common in the patent world, however, and confer non-tax business benefits. An inventor transferring a patent to a holding corporation that was created specifically for receiving the patent is an insufficient reason to apply the substance over form doctrine. Second, although Charlson was not a shareholder and Cooper and Lee were, all of the other shareholders of the transferee corporations were close friends of the inventors. There is no evidence that any of the shareholders had knowledge of the patent business, but this was only raised as an issue in **Cooper**. There, both the Tax Court and the Ninth Circuit seemed bothered by the lack of patent experience of Walters and Coulter despite their business and professional experiences. The **Cooper** court was additionally concerned about whether Cooper chose his shareholders so that he could control them, especially considering the failure of his previous business relationship. Section 1235 does not place requirements on the nature of an inventor’s relationship with the transferee corporation’s shareholders, so long as they are not related parties under the provision. It is logical that Cooper, after a failed business relationship, would choose to enter a new endeavor with people he knew and trusted. Charlson also chose his friends, and Lee chose his old coworker who invented the patent with him. There is little logic in assuming that Cooper’s interest in working

\(^{133}\) *Id.*

\(^{134}\) *Id.* at 1096-97.

\(^{135}\) *Id.*

\(^{136}\) *Id.*

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with people he knew somehow equated to his ability to control them.

Third, the corporations relied on the inventors for their expertise, guidance, and knowledge of their patents. Involving the inventor with decisions about his invention is common practice and ideal for the invention, the inventor, and for the holding corporation. The inventor’s knowledge and expertise undoubtedly increase the patent’s value, which in turn increases stock value. Whereas this arrangement was viewed as typical and beneficial in Charlson, the Cooper court imputed nefarious intent by using the shareholders’ reliance on Cooper’s expertise and guidance as evidence that he was controlling them.

The distinction between the cases may be whether the government argued substance over form. When the Charlson and Lee courts analyzed the issue of control, they concluded that the taxpayer inventors were permissibly operating under § 1235; when the Cooper court analyzed similar transactions, however, it concluded that the substance over form doctrine mandated a different result. The Cooper court distinguished Cooper from Charlson because the corporation in Charlson “never returned patents to the inventor without consideration.” However, as discussed below, the application of the substance over form doctrine erroneously shifted the court’s focus of the § 1235 analysis from the taxpayer to the corporation’s business decisions. Its conclusion was, therefore, speculative and tainted by the doctrine.

While courts do have a duty to examine the circumstances behind a taxpayer’s challenged transactions, the Cooper result suggests that the substance over form doctrine has the (perhaps unintentional) effect of acting in a conclusory manner. In other words, after deciding that the substance over form doctrine is applicable to a transaction, a court might support the doctrine rather than undertake a neutral analysis of the case.

B. Consequences of the Cooper Decision

The Tax Code has hundreds of provisions. The Code informs taxpayers of their duties and allows them to structure their transactions to their benefit. Taxpayers pay taxes; the Code puts them on notice of the tax consequences of their actions.

While there will always be room to argue in the gray spaces of the Code, the Cooper decision adds unnecessary uncertainty for inventors. By erroneously applying the substance over form doctrine, the Cooper court redefined the control requirement of § 1235. Congress included § 1235(c) to assuage its concerns about inventor control in holding corporations, but the Cooper court seemed to not be

137. Granted, the fact that the corporation gave back some patents does suggest some indicia of improper control, but the corporation’s directors may have transferred the patents for many reasons—perhaps for good business relationship reasons, perhaps because they exercised terrible business judgment—but the transfer is not necessarily indicative of effective control by the inventor. Because it could have happened for other reasons, this Author is under the opinion that the taxpayer should have received the benefit of the doubt.

138. Cooper, 877 F.3d at 1093 (majority opinion). The transfer of an asset carries with it its own taxation consequences for both the corporation and the individual. See I.R.C. §§ 301, 311 (2012).

139. See infra Section IV.B.

140. Section 1235 is arguably not very gray.
satisfied with Congress’s method. Because Cooper so clearly met the statute’s control requirement, the Cooper court had to wrestle control into another of § 1235’s elements. Although the all substantial rights element is not about control per se, as evidenced in its corresponding regulations, the court made it about control for the purposes of denying Cooper § 1235’s benefits.

This misguided focus took the attention away from the inventor and whether he retained rights, and instead looked at the corporation and its actions. It seems that the Cooper court made its decision about whether the taxpayer gave away all substantial rights by analyzing the transferee corporation’s business decision. The dissent’s definition of control in the § 1235 context was better: the question is not whether a corporation took an action; the question is whether the corporation could have refused to take the action.

Ultimately, the Cooper decision may deter inventors from pursuing § 1235’s tax benefits and the incentive to invent, move, and share patents may be lessened. For rules to work effectively, taxpayers must be able to follow them. After Cooper, inventors may be unsure of how to best comply with the requirement regarding control. Although the Code and the regulations lay out the parameters of the requirement, Cooper demonstrates that an inventor is not necessarily safe if she follows those parameters; rather, she must show no appearance of control as well. The easiest way to satisfy this would be to sell her patent to an unknown third party, but the Code does not require that.

Regarding control, § 1235 tells us that the inventor cannot own more than 25% of the corporation to which the patents are transferred and that the other shareholders cannot be “related parties.” What do Charlson, Lee, and Cooper add to our understanding? It is acceptable to start a corporation for the purpose of transferring your patents, to be a shareholder in that corporation, and to have your closest friends and employees as shareholders and corporate directors. It is also acceptable to advise the corporation. It is not acceptable, however, to do those things if the corporation makes a business decision that a court would not have made.

As Judge Kleinfeld pointed out, “Congress thought it was a good idea to give patent holders a tax benefit, but the majority’s decision creates so much risk of litigation that it may be a bad idea to claim the benefit.” Of course, it is not so clear after the Tax Cuts and Jobs Act whether, or for how long, Congress will continue to give patent holders a tax benefit.

141. An exploration of whether this might be a modified form of veil piercing is outside the scope of this Note.
142. Cooper, 877 F.3d at 1097 (Kleinfeld, J., dissenting).
143. There is evidence that tax incentives may, indeed, affect the incentive to invent. See Ufuk Akcigit et al., Taxation and Innovation in the 20th Century 5 (Nat’l Bureau of Econ. Research, Working Paper No. 24982, 2018).
144. This might not be the best course of action for the patent’s future, either.
145. Cooper, 877 F.3d at 1099 (Kleinfeld, J., dissenting).
C. Suggestions

1. Substance over Form Doctrine Should be Applied More Narrowly

Anti-abuse doctrines can be useful and the IRS should have the protection of the substance over form doctrine when a taxpayer blatantly disregards the requirements of the Code. The doctrine can no doubt help protect against untoward taxpayer schemes.146 The doctrine should not, however, be applied in any circumstance in which the government merely does not like the result of a transaction.

The Ninth Circuit, agreeing with the Commissioner’s substance over form argument, interpreted the doctrine as “look[ing] beyond the bare form of the transaction.”147 A court should, of course, look beyond the bare form, but the doctrine implies something more than a look. The doctrine implies that if the government is applying it, something is amiss. This is faulty logic because the government applies the doctrine when it does not like the result of a taxpayer’s transactions, but not liking the result of a transaction does not mean that the transaction occurred outside of the legitimate boundaries of the Code.

The First Circuit’s application of the substance over form doctrine is a better standard. Even if the doctrine is argued in a case where the government merely does not like the outcome, it will not automatically weigh against the taxpayer if a court treats the doctrine as a tool of statutory interpretation. Cooper may have followed Charlson and Lee under this standard.

Moreover, the substance over form doctrine should generally be applied more narrowly. The doctrine should be reserved for those times when a taxpayer truly mischaracterized or mislabeled something in search of a benefit to which the taxpayer was not entitled. A taxpayer should not be able to label their dog a cow in order to receive cow subsidies. But the doctrine should not apply if the government disagrees with a dog owner receiving cow subsidies after she purchases cows in order to receive the subsidies.

Because § 1235’s elements are clearly defined, it is difficult to imagine a scenario where the substance over form doctrine’s application would be necessary to defeat a taxpayer’s inappropriate use of the provision. The statute itself is sufficient to strike down the use of § 1235 for a taxpayer who mischaracterizes or mislabels his transactions, or otherwise attempts to bamboozle the IRS. In light of § 1235’s clarity, substance over form is an unnecessary doctrine.148

The Code has grown.149 Of the many provisions Congress has added are a handful of specific situations in which the IRS is given the express authority to

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146. See Mazzei v. Comm’r, 150 T.C. 7, 78 (2018) (Holmes, J., dissenting) (“If a kennel and a taxpayer agree that a tail is a leg, a taxpayer might say he has a five-legged dog. But unless the Code or regulations tell us differently, his dog still has only four legs for tax law.”).

147. Cooper, 877 F.3d at 1091 (majority opinion).

148. Because comprehensive Code revisions and additions have replaced piecemeal common law, the use of judicially-created doctrines may no longer be appropriate in tax cases at all. See Madison, supra note 55, at 716.

149. During the days of Gregory, the Code fit on 400 pages; it now takes over 36,000. Id. at 745.
recharacterize transactions using substance over form principles. On the one hand, the fact that Congress has built substance over form into the Code lends support to its use generally. On the other hand, the fact that Congress has only built it into certain provisions and not as an overarching principle applicable to the whole Code implies that Congress does not intend for the doctrine to be applied willy-nilly.

2. Congress Should Clearly Speak to Inventions and Capital Gains Treatment

Section 1235 was almost repealed. By expanding § 1221, the Tax Cuts and Jobs Act specifically excluded the income from the sale or exchange of a patent from receiving capital gain treatment under general characterization principles, and the House’s accompanying repeal of § 1235’s special characterization rule would have closed the door to capital gain income for inventors. Is this what Congress intended? In light of the Code’s general pronouncement that self-made goods are not capital assets, it would not be nonsensical for Congress to make this change. If Congress intended to close the door to capital gains income for inventors, it needs to remove the ambiguity. One way to make this intention clear is to redefine the definition of “holder” in § 1235 to exclude the inventor.153

It makes better sense, however, to encourage invention by offering tax benefits to inventors. “It is widely accepted by economists and nations alike that innovation drives economic prosperity.” The recent tax bill, however, shows a decisive move away from encouraging innovation. Attempting to stimulate the economy by offering tax breaks for tangible machines and manufacturing equipment instead of innovation and invention was simply “short-sighted.”

Of the many ways Congress chose to actively discourage innovation in America, it made the above changes to § 1235, eliminated the research and development tax deduction, and failed to adopt a patent box. Innovation may suffer and/or move offshore as a result. While the United States has fallen from its position “at the forefront of innovation policy,” many other nations are employing strategies to increase innovation, including tax incentives to become more competitive.
Cooper was denied capital gain treatment on his patent royalty income despite following the Code’s requirements under § 1235. The overreaching application of the substance over form doctrine led the Tax Court and the Ninth Circuit to the conclusion that Cooper effectively controlled the corporation to which he transferred his patents despite satisfying Congress’s control requirement.

While the substance over form doctrine may have had its use when the Code was young, it is now applied too widely and at the expense of taxpayers. A consistent, functional approach is necessary, with a uniform definition of what the doctrine is and when it should be applied. If it is to be used, the substance over form doctrine should be reserved for those situations when a taxpayer mischaracterizes or mislabels a transaction to receive an illegitimate benefit. The fact is that the Code may bestow benefits on taxpayers that the government does not agree with, but this does not mean that the substance over form doctrine should swoop in against the taxpayer.

In the end, taxpayers have a duty to pay taxes, but they do not have a duty to pay more than their due. Taxpayers require clarity in order to know the taxation consequences of how they arrange their affairs. Although Congress needs to resolve the Code’s internal inconsistency in its treatment of income from the sale or exchange of patents resulting from the recent Tax Cuts and Jobs Act, § 1235 and its elements provide the clarity necessary for an inventor to receive its benefits. The Cooper decision unnecessarily complicates the provision’s requirements.

When the Code allows taxpayers to structure their transactions to benefit them, the Service must accept that reality. If it is displeased with how a taxpayer follows the Code, it can issue regulations or wait for Congress to fix the problem. It should not, however, use the courts to take its displeasure out on taxpayers.
