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Marquette Intellectual Property Law Review

Volume 24 | Issue 1 Article 8

Winter 2020

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Recommended Citation

Christina Sumer, *Determining Patent Worthlessness for Tax Purposes*, 24 Marq. Intellectual Property L. Rev. 1 (2020)

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DETERMINING PATENT WORTHLESSNESS FOR TAX PURPOSES

CHRISTINA SUMER

I. INTRODUCTION

Patent valuation is a complex, occasionally confusing concept that has become somewhat of a gray area in intellectual property. Patent value is "the economic benefit that the patent can bestow upon its owner."[1] It involves determining a patent's monetary value to the patent's owner, which can prove difficult based on the fact that patents are inherently unique.[2] Generally, the more significance a patent has to society, the higher its value.[3] There are currently seven different valuation methods used for valuing intellectual property.[4] They include the following: the twenty-five (25) Percent Rule, Industry Standards, Ranking, Surrogate Measures, Disaggregation Methods, the Monte Carlo Method, and Option Methods.[5] While these are all widely used methods, none of them are definitive, and they are continually being updated.[6] In fact, the Federal Circuit recently held that the twenty-five (25) Percent Rule is flawed, and it would no longer be accepting evidence using that method.[7]

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1. Michael S. Kramer, *Valuation and Assessment of Patents and Patent Portfolios Through Analytical Techniques*, 6 J. MARSHALL REV. INTELL. PROP. L. 463, 465 (2007).

2. *Id.*

3. *Id.* at 466.

4. Ted Hagelin, *Valuation of Intellectual Property Assets: An Overview*, 52 SYRACUSE L. REV. 1133, 1134 (2002).

5. *Id.*

6. *Id.* at 1139–40.

7. Uniloc USA, Inc. v. Microsoft Corp., 632 F.3d 1292, 1315 (Fed. Cir. 2011).

On the opposite end of this valuation spectrum is determining when a patent has no value and has become worthless or obsolete.[8] Patents are generally granted for a seventeen-year period, and throughout the life of a patent, the patent holder can take tax deductions for things such as amortization or normal wear and tear.[9] Tax deductions can also be taken for patent obsolescence or "worthlessness."[10] If the patent becomes worthless before its expiration year, the unrecovered cost may be deducted in that year.[11] However, there have not been many case discussions on what determines when a patent is "worthless" or when exactly a patent has become obsolete for purpose of these tax deductions. According to the Merriam-Webster dictionary, obsolescence is "the process of becoming obsolete or the condition of being nearly obsolete . . . ."[12] While this definition is easy enough for most to understand, albeit somewhat obvious, it does nothing to further the question of when a patent has reached that point. Much of the same can be said for the case law surrounding the topic, which is the crux of the problem.

The most recent cases discussing patent obsolescence can be sourced back to the 1920s and 1930s with *Tennessee Fibre Co. v. C.I.R.* and *Hazeltine Corp. v. C.I.R*. These cases came about during the height of the "paper patent" doctrine, which differentiated patents based on whether or not they had ever been put to use.[13] The outcomes of these cases reflected the times. Both the *Tennessee Fibre Co.* and *Hazeltine* decisions rested on the actual use of the patent in determining its value.[14]

This comment considers a key question: what is the correct method for determining patent worthlessness or obsolescence? Is it the method used almost a century ago? Part II of this comment will delve into the paper patent doctrine and its effect on the question. Part III will further look at how this paper patent approach has been applied toward evaluating patents. In contrast, Part IV will look into the approach that has more recently been applied. This newer method involves a two-prong test of subjective and objective factors.[15] Finally, in Part V, this Comment will conclude by assessing what is the correct

8. It should be noted, throughout this comment these terms may be used interchangeably, seeing that much of the case law uses "worthlessness" when talking about obsolescence.

9. Mertens Law of Federal Income Taxation, 22C:31 Depreciation of Patents, Westlaw.

10. Treas. Reg. 1.167(a)–9.

11. Treas. Reg. 1.167(a)–6(a).

12. *Obsolescence*, Merriam-Webster.com, https://www.merriam-webster.com/dictionary/obsolescence.

13. John F. Duffy, *Reviving the Paper Patent Doctrine*, 98 CORNELL L. REV. 1359, 1360 (2013).

14. Tenn. Fibre Co. v. C.I.R., 15 B.T.A. 133, 140 (B.T.A. 1929); Hazeltine Corp. v. C.I.R., 89 F.2d 513, 521–22 (3d Cir. 1937).

15. Precision Pine & Timber, Inc. v. C.I.R., T.C. Summ.Op. 2003-19, *6 (2003).

approach that should be used when discussing patent worthlessness. Because of the definitiveness of the newer test, it should be the chosen method for determining when a patent becomes worthless.

II. THE "PAPER PATENT" ERA

Until the 1950s, the "paper patent" doctrine was an integral part of intellectual property.[16] As previously mentioned, this doctrine correlated to patent use.[17] Courts distinguished patents on whether or not the patent was actually used.[18] Those that were not used were referred to as "paper patents," and courts were more inclined to hold them invalid.[19] Though its importance remained somewhat relevant until the early 1980s, it completely died with the creation of the Federal Circuit in 1982.[20] There was no definitive explanation given for the shift, but an important question had arisen during the doctrine's heyday, which looked at why a patent's nonuse was considered an unfavorable factor.[21] The problem this posed is what eventually led to all patents being held in equal light regardless of their use.[22]

Though there was no explicit explanation given for the end of the paper patent era, one source of its demise was the emergence and domination of the "documentary disclosure" theory.[23] This theory stands for the fact that the only statutory disclosure required for patents is set forth in the patent document.[24] It is "the *quid pro quo* of the right to exclude."[25] Therefore, it is a paper disclosure set by a minimal standard.[26] Because the only requirement for patents is this paper disclosure, there is to be no discrimination against paper patents.[27]

Furthermore, today's modern patent lawyers believe inventions can come about by two ways: through "actual reduction to practice" or "constructive reduction to practice."[28] An actual reduction to practice means the patent application can actually work in the real world.[29] A constructive reduction to

16. *See* Duffy, *supra* note 13, at 1360.
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id*.
21. *Id.* at 1388.
22. *Id.*
23. *Id.* at 1361.
24. *Id.*
25. J.E.M. Ag Supply, Inc. v. Pioneer Hi-Bred Int'l, Inc., 534 U.S. 124, 142 (2001) (quoting Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 484 (1974)) (emphasis added).
26. Duffy, *supra* note 13, at 1362.
27. *Id.* at 1364.
28. *Id.* at 1366.
29. *Id.*

practice means the invention of the patent itself need not have actually been tested prior to being patented.[30] The only requirement is that it could work if it were actually built.[31] This latter theory is somewhat in conflict with the paper patent doctrine, and its acceptance by modern patent lawyers helps clarify why the paper patent doctrine is no longer in use.

The influence of the paper patent doctrine in the first half of the twentieth century was widespread in intellectual property. This explains why much of the litigation of patents occurred during this time, and it also explains why the holdings in those cases turned out the way they did. This comment will now look at these cases in more depth to see the repercussions this standard had.

III. THE PAPER PATENT ERA'S INFLUENCE ON PATENT WORTHLESSNESS

The first such case involving the paper patent's influence on patent worthlessness was *Tennessee Fibre Co. v. C.I.R.* In this case, the petitioner held a patent for a process that separated the cotton fiber from its seeds, with the byproduct being bleached.[32] This process and its resultant product became very useful for gun cotton, and it was sold exclusively to munitions manufacturers throughout the early 1910s.[33] However, the petitioner's success changed after the end of World War I in 1918.[34] With no more weapons needed to supply a war, there was no longer any demand for the product, and the petitioner determined the patent to be valueless.[35] On his income taxes for 1918, he claimed a deduction for obsolescence, which was disallowed by the Service.[36]

The petitioner argued that under IRC section 234(a), now IRC section 167[37], he could take an obsolescence deduction.[38] On review, the Board of Tax Appeals agreed with the petitioner that there was no longer any use for the patent because the market it served was completely wiped out,[39] notwithstanding the fact that unbeknownst to everyone involved in the case World War II would open that market back up in a few years. The court did,

30. *Id.*
31. *Id*.
32. Tenn. Fibre Co. v. C.I.R., 15 B.T.A. 133, 134 (B.T.A. 1929).
33. *Id.* at 135.
34. *Id*. at 138.
35. *Id.*
36. *Id.*
37. Major tax code updates, notably in 1954 and 1986, changed code sections. Substantive changes were made, but sometimes, as the case here, there were only changes with reference to the specific code number.
38. *Id.* at 138–39.
39. *Id.* at 140.

however, rule against the petitioner because he had not abandoned the patent.[40] He continually put money into it, trying to find a use for it, and the court focused on this in determining the patent was not completely obsolete.[41] This focus on the patent's use was the tipping point in the court's analysis.[42]

The next case to come about in the paper patent era was the aforementioned *Hazeltine* case, which involved a patent for the composition of radio receivers.[43] The petitioner, in determining that the patents became obsolete as a result of new technology, took a large depreciation deduction on his company's income tax return for the year.[44] The Commissioner originally disallowed the depreciation taken, reasoning that the depreciation should have been amortized over a longer period of time because the life of the patent was not over.[45] However, upon review, the Third Circuit Court of Appeals sided with the petitioner, holding that patent obsolescence related to use.[46] The patents here were obsolete because "they had gone completely out of use and no longer had any practical commercial value."[47] In reaching this conclusion, the court made a distinction between obsolescence and complete obsoleteness:

> It is of course true that the Neutrodyne circuit continued capable after 1930, of performing, for those who still desired to use it, the same function in radio reception which it had theretofore performed, and it may well be that a few persons did continue to use it after that time. This, however, is far from saying that it was not obsolescent so far as practical commercial use or public acceptance was concerned, since, as we have seen, all the evidence bearing on the question indicates that it was substantially out of all commercial use by the end of that year.[48]

The issue with both *Tennessee Fibre Co.* and *Hazeltine* is that they employ an arbitrary use standard influenced by the paper patent era. Critics of the "paper patent[49] Both cases support the critics. As previously mentioned, World War II would open the market back up for gun ammunitions in a few years, but the court in *Tennessee Fibre Co.* decided that because there was no use for the

40. *Id.*
41. *Id*.
42. *Id.*
43. Hazeltine Corp. v. C.I.R., 89 F.2d 513, 515 (3d Cir. 1937).
44. *Id.* at 517.
45. *Id*. at 521.
46. *Id.* at 521–22.
47. *Id.* at 521.
48. *Id.* at 522.
49. Duffy, *supra* note 13, at 1360–61 (quoting Frank B. Killian & Co. v. Allied Latex Corp., 188 F.2d 940, 942 (2d Cir. 1951).

patent at that particular moment in time, the petitioner could have called his patent worthless had he not still been trying to find a use for it.[50] What would have happened, then, to his patent at the start of World War II? Could the petitioner have attempted to use it again? While there was not follow-up to this case discussing the petitioner's luck with the patent during the second world war, there may be an issue with a taxpayer using a patent that he already claimed on his tax returns to be worthless.

This scenario would certainly call into question the application of the tax benefit rule. This concept requires a taxpayer to include in his gross income the amount that was previously deducted if "the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based."[51] Its premise relies on maintaining balance.[52] It remedies the situation "when an apparently proper expense turns out to be improper."[53] The tax benefit rule applies to a variety of tax situations, including those regarding corporate dividends, ordinary and necessary business expenses, and the amount of damages correctly included in a taxpayer's gross income. [54]

Though the taxpayer may simply have to later include this amount in his federal income taxes, there is another issue posed on how many times the taxpayer could do this. For instance, a taxpayer may find it beneficial to structure his tax returns by taking the obsolescence deductions in years where he has greater income and then later paying the deducted amount on his income tax return the next year when it would not cause as big of a financial hit. This potential abuse of the tax code points out the problems with the court's decision to call the patent worthless for tax purposes based on pure speculation. There was no way the court could have known World War II would break out shortly thereafter, and perhaps another test employed would still reach the same conclusion that court came to, but the nature of the court's "use" test leaves it with more opportunity to get the outcome wrong and cause confusion later on.

These same issues can be seen with the *Hazeltine* case. The court also held in that case that new technology made the patent worthless and capable of the obsolescence deduction, but there was not enough of a discussion on why that was so, with the only reason given being that newer technology had been developed that was presumptively better than the petitioner's.[55] In the 21st century, technology is constantly evolving. If newer technology means that all

50. Tenn. Fibre Co. v. C.I.R., 15 B.T.A. 133, 140 (B.T.A. 1929).

51. Hillsboro Nat. Bank v. C.I.R., 460 U.S. 370, 383 (1983).

52. *Id.* at 389 n.24.

53. *Id.* at 389 n.24.

54. *Id.* at 392; Byrd v. C.I.R., 1987 WL 38627, at *1 (1987); Citigroup, Inc. v. United States, 140 Fed. Cl. 283, 284–85 (2018).

55. Hazeltine Corp. v. C.I.R., 89 F.2d 513, 521 (3d Cir. 1937).

previous technological advancements are rendered obsolete, then the Service is going to see an influx of these worthlessness deductions being claimed. A purely subjective determination on use will, again, result in potential issues arising later on. While it is possible that the same conclusion and issues may arise with another test, that overlap should still be less likely. It is also important to consider whether this test is simply a way for taxpayers to make money quickly by way of tax breaks rather than based on actual need.

Issues with these two cases were indirectly discussed in *Western States Machine Co. v. S.S. Hepworth Co.*, one of the first cases that marked the end of the paper patent era.[56] This was a patent infringement case involving sugar centrifuges, with the plaintiff alleging that the defendant infringed on his earlier ideas.[57] There had been a twenty-one year gap between the patents, and despite the first patent's nonuse and making "no impression on the art," the court held that irrelevant.[58] Judge Learned Hand, a strong critic of the paper patent doctrine, expressed his belief that an unused patent should in no way negatively impact the way the case was decided:

> A patent may have lain for years unheeded, as little contribution to the sum of knowledge as though it had never existed, an idle gesture long since drifted into oblivion. Nevertheless, it will be as effective to invalidate a new patent, as though it had entered into the very life blood of the industry.[59]

The opinion further called the term "paper patent" merely rhetoric, and held for the plaintiff.[60] As seen in the case, the use standard was not a good enough test for a patent infringement case, so it is difficult to conceive why it should be good enough for determining patent worthlessness. The criticism of the paper patent doctrine and the rejection of the nonuse standard in this case played a big part in its decline.[61]

IV. THE NEWER TAX APPROACH

The shortcomings of the paper patent doctrine's use standard has left an opening for a different standard to be explored. As readily seen, the cases discussed in this section occurred after the end of the paper patent doctrine in the 1980s, so they were of the time when there was still not an adequate

56. Duffy, *supra* note 13, at 1383.
57. W. States Mach. Co. v. S.S. Hepworth Co., 147 F.2d 345, 346 (2d Cir. 1945).
58. *Id.* at 350.
59. *Id.*
60. *Id.*
61. Duffy, *supra* note 13, at 1383.

standard. The newer tax approach that has been employed leaves much less room for guesswork resulting from the arbitrary, subjective tests previously employed by the courts. The Internal Revenue Code (IRC) and the Treasury Regulations are clear that a taxpayer can take tax deductions for obsolescence.[62] IRC § 167 codifies this right by stating "exhaustion, wear and tear, and obsolescence are to be allowed…"[63] Its accompanying treasury regulation covers what obsolescence means in further detail:

> The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supersession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete.[64]

There have not been any cases specifically involving patents that have used this regulation's guidance. That particular application has, unfortunately, not yet come up. However, there have been cases involving intangible assets.[65] These cases have expanded on what a showing of worthlessness requires.

One of the first of the case discussions occurred in *Echols v. C.I.R.* The intangible assets involved were interests in a partnership that the taxpayers claimed became worthless.[66] It is here that the court developed the test for

62. I.R.C. 167(c); Treas. Reg. 1.167(a)–9; Treas. Reg. 1.167(a)–6(a).

63. I.R.C. 167(c).

64. Treas. Reg. 1.167(a)–9.

65. Echols v. C.I.R., 935 F.2d 703, 704–05 (5th Cir. 1991) (applying obsolescence to partnership interests); Precision Pine & Timber, Inc. v. C.I.R., T.C. Summ. Op. 2003–19, *4 (2003) (applying obsolescence to covenants not to compete); In re Steffen, 305 B.R. 369, 373 (Bkrtcy. M.D. Fla. 2004) (applying obsolescence to stocks).

66. Echols, 935 F.2d at 704.

determining worthlessness.[67] The court noted that it is clear that property cannot be treated as worthless if it has substantial value, but the issue of when the property loses its value for tax purposes "is, like beauty, largely in the eyes…of the beholder."[68] To solve that, the court implemented a test that involved a subjective determination on the part of the taxpayer coupled with an objective event.[69] The court was careful to espouse the different standards for determining abandonment of an intangible asset and the worthlessness of that asset, thus indicating the two are separate concepts.[70] Making the standard clear, the court applied the test to the intangible assets:

> Emphasizing again that the asset being tested for worthlessness is not the Land but the Taxpayers' 75% interest in the Partnership which owned the Land, we must determine *subjectively* just when it was that the Taxpayers deemed their Partnership interest worthless, then determine *objectively* whether that interest was valueless at such time.[71]

After applying the test, the court held for the taxpayer.[72] Shortly after this decision, the Fifth Circuit defended the validity of its test when asked by the Commissioner to reconsider its treatment of worthlessness.[73] The Court reiterated the test and further stated the objective part should be an "identifiable event" or completed transaction.[74] The Court left the latter requirement broad, indicating that it does not have to be a property transaction or even include the asset in question.[75]

This test was further honed in *Precision Pine & Timber, Inc. v. C.I.R.* The intangible assets involved were covenants not to compete in logging contracts entered into by the petitioner.[76] After a logging injunction was issued in Arizona to protect an endangered species, the petitioner deducted the value of three covenants not to compete.[77] To assess the validity of the deductions, the Court, following *Echols*, stated the evaluation of worthlessness was a two-pronged test.[78] In the first prong, the Court is to determine whether the taxpayer

67. *Id.* at 707.
68. *Id.*
69. *Id.*
70. *Id.*
71. *Id.*
72. *Id.* at 709.
73. Echols v. C.I.R., 950 F.2d 209, 213 (5th Cir. 1991).
74. *Id.* at 211.
75. *Id.*
76. Precision Pine & Timber, Inc. v. C.I.R., T.C. Summ.Op. 2003–19, *1 (2003).
77. *Id.* at *1–2.
78. *Id*. at *4.

"made a subjective determination that the asset in question was worthless in the tax year in question."[79] Here, the taxpayer satisfied the first prong by showing that the logging industry in the area had collapsed, resulting in him reporting unamortized amounts as a loss on his corporate tax returns.[80] In the second prong, the taxpayer must show an identifiable event "evidencing the destruction of an asset's value."[81] Like the regulations stated, if there was a reasonable possibility that the asset will have a future value, the second prong of the test fails.[82] The identifiable event here was a statewide logging ban, thus making it impossible for the covenantees to compete and ensuring that the asset could not possibly have any future value.[83]

The identifiable event of the second prong takes more than a mere decline in the asset's value.[84] It would take something such as formal bankruptcy or market conditions to satisfy it.[85] Until the "last vestige of value has disappeared," a worthlessness deduction cannot be taken.[86] This test is also not satisfied just because something, such as a partnership, is not properly managed.[87]

It is clear that the case law in this area is plentiful and at the point where the test has been adequately defined with enough variations to cover a wide variety of situations. Though it has not been applied to any patents, it has been applied to many intangible assets. Because patents are considered intangible assets, there is no discernable reason why this area could not expand to include patents.

V. WHICH STANDARD IS BEST FOR PATENTS?

The use standard of the paper patent era has already been hit with much criticism, which contributed to its decline.[88] This criticism stemmed from a

79. *Id.* at *5.

80. *Id.* at *6.

81. *Id*.

82. *Id*.

83. *Id.*

84. Forlizzo v. C.I.R., T.C. Memo 2018-137, *3 (2018) (holding that a taxpayer could not take an obsolescence deduction for his interest in real estate development partnerships because of a failure to show a closed and completed transaction).

85. *Id.*

86. In re Steffen, 305 B.R. 369, 375 (Bkrtcy. M.D. Fla. 2004).

87. Lebow v. C.I.R., T.C. Memo. 1995-333, *4–5 (1995) (holding that just because petitioner could not secure any information or distributions from partnership did not mean that his interest in it was worthless).

88. W. States Mach. Co. v. S.S. Hepworth Co.,147 F.2d 345, 350 (2d Cir. 1945); Frank B. Killian & Co. v. Allied Latex Corp, 188 F.2d 940, 942 (2d Cir. 1950) (holding that the paper patent doctrine is merely "rhetoric" and a "meaningless platitude"); Siegel v. Watson, 267 F.2d 621, 624 (D.C. Cir. 1959).

fundamental flaw with the doctrine that could not be squared. In his analysis of the paper patent doctrine, John Duffy summed up its issues as follows:

> Criticism from famous judges, especially Learned Hand, was clearly a significant factor in the doctrine's decline, but such prominent criticism was only part of the story. The more general problem was that the doctrine never had a rigorous theoretical justification. It was an intuition…one that could not be grounded in the basic purposes of the patent system as they were understood in the latter half of the twentieth century. The absence of that theoretical justification led to the decline.[89]

Duffy's criticism is spot on. There is no actual justification for why there should be an arbitrary use standard. As mentioned, modern patent lawyers believe in the concept of "constructive reduction to practice."[90] A patent just has to be capable of working, but the patentee need not have actually built in or used it in the real world.[91] These patents are every bit as good as those covered by the concept of "actual reduction to practice," i.e. those that are actually used in the real world.[92] Even the courts have fully embraced this concept.[93] Since the use standard of the paper patent era has been rejected, applying it to patent worthlessness or obsolescence seems futile.

Compared to the use test that stems from the paper patent doctrine, the two-prong test that came about in *Echols* is much clearer. It takes into account not only the petitioner's subjective belief that a patent is obsolete but it also requires an objective determination, guided by some event, that a court can use to make an informed decision.[94] A clear test will provide guidance and ensure there will be equal treatment for all cases as opposed to varying conclusions courts could reach when applying a different, broader standard. Additionally, this test makes the tax code and treasury regulations less likely to be abused. As stated in the follow-up opinion in *Echols*, a taxpayer cannot "arbitrarily deduct a loss in any year he chooses."[95] There has to be some objective support for that determination.[96]

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89. Duffy, *supra* note 13, at 1383.

90. *Id.* at 1366.

91. *Id.*

92. *Id.* (quoting Lisa A. Dolak, *Patents Without Paper: Proving a Date of Invention with Electronic Evidence*, 36 HOUS. L. REV. 471, 491–92 (1999)).

93. Duffy, *supra* note 13, at 1371.

94. Echols v. C.I.R., 935 F.2d 703, 707 (5th Cir. 1991).

95. Echols v. C.I.R., 950 F.2d 209, 213 (5th Cir. 1991).

96. *Id.*

Had this test been around when the *Hazeltine* case was decided, it is likely that the outcome would have been different. A court today could conclude that the facts of that case did not satisfy the second prong because there was neither an identifiable, objective event evidencing obsolescence nor, as the court in *In re Steffen* put it, had the "last vestige of value" of the patent disappeared.[97]

VI. CONCLUSION

Though there have not been many worthlessness or obsolescence cases regarding patents in the last eighty years or so, it is still important to look at this area of case law because of the different reasoning the courts have used to reach decisions. The cases on patent obsolescence from the paper patent era are still considered good law, so a determination needs to be made if future patent obsolescence cases should follow their logic. This comment's assessment of that era's reasoning concludes future cases should not. The reasoning of those cases was too broad and had no uniform justification on how decisions were reached.

The approach that should be followed is the most recent test employed, which is not a product of the paper patent era. It provides a clearer standard for courts to use that will be subject to less abuse. By giving the taxpayer his subjective say in the matter and checking that by an objective event the court can look to, it provides the fairest result. Additionally, there is less of a chance for courts to reach an outcome that may have later tax complications.

97. In re Steffen, 305 B.R. 369, 375 (Bkrtcy. M.D. Fla. 2004).