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TRANSFERS OF KNOW-HOW UNDER SECTION 351*

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INTRODUCTION

Transfers of technical information, in particular, know-how, by a domestic parent corporation to a controlled foreign subsidiary pose difficult tax problems for the domestic parent. Section 351(a) of the Internal Revenue Code provides that:

> [N]o gain or loss shall be recognized if property is transfered to a corporation by one or more persons solely in exchange for stock or securities[1] in such corporation and immediately after the exchange such . . . persons are in control[2] . . . of the corporation. For pur-

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[1] If the taxpayer fails to receive stock or securities in exchange for the transfer of property, the transaction will likely be treated as an ordinary sale or exchange. Any gain in excess of the adjusted cost of the property transferred will be fully taxable. If, however, the property qualifies as a capital asset under section 1221, and if the requirements of section 1231 or section 1235 are met, a transfer of technology may qualify for special capital gains treatment. See text accompanying notes 54-104 *infra* which discusses this issue with respect to transfers of know-how in conjunction with transfers of patents, secret formulas, and secret processes.

However, in certain circumstances even capital gains treatment will be denied transfers of technology, even though the transaction would otherwise qualify for capital gains treatment. Where the property exchanged is "a patent, an invention, model, or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right," and the transfer is to a foreign corporation "controlled" by the transferor, any gain will be taxed at ordinary rates. Control is defined as "more than 50 percent of the total combined voting power of all classes of stock entitled to vote." I.R.C. § 1249. Thus if a transfer should fail because stock or securities in the transferee was not received in exchange, or because the transferor did not have 80% control of the corporation after completion of the transfer (*see* note 2 *infra* and accompanying text) but had the requisite 50% control, there will be no special capital gains rate applicable to the transfer.

Section 1249 would presumably come into play also when the taxpayer met the requirements of section 351, but failed to comply with the requirements established under section 367 with respect to tax-free transfers of property to foreign corporations. Otherwise, if the transfer qualifies under section 351, there will be no taxable event, and the transaction will not be subject to tax under section 1249. S. REP. No. 1881, 87th Cong., 2d Sess. (1962), *reprinted in* 1962-3 C.B., at 1013. *See* J. BISCHEL, TAXATION OF PATENTS, TRADEMARKS, COPYRIGHTS, AND KNOW-HOW ¶ 6 (1974, Supp. 1976).

[2] Control for the purposes of section 351 is defined in section 368(c) as "the ownership

> poses of this section, . . . services shall not be considered as property.

Although in foreign transfers the transferor must also satisfy the reporting requirements under section 367,[3] it is the ambiguous

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of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

Note that, under the new rules for section 1491 imposed by the Tax Reform Act of 1976, a transfer which fails to qualify under section 351 may be subject to a 35% excise tax. Section 1491 imposes an excise tax of 35% "on the *transfer of property* by a citizen or resident of the United States, or by a domestic corporation or partnership, or by a trust which is not a foreign trust, to a *foreign corporation as paid-in surplus or as a contribution to capital,* or to a foreign trust, or to a foreign partnership. . . ." The tax is imposed on the difference between the fair market value of the property transferred and the sum of the taxpayer's adjusted basis in the property and the amount of gain recognized to the transferor at the time of the transfer.

The excise tax of section 1491 is not imposed on transfers which qualify for consideration under section 367. I.R.C. § 1492(3). However, one should note that the excise tax applies to transfers of "all types of property." S. REP. No. 94-938, 94th Cong. 2d Sess. 222, *reprinted in* 1976-3 (vol. 3) C.B., at 260. Therefore, if one transfers technology to a foreign corporation, and does not qualify the transfer under section 351 or a related section subject to 367, and the Service considers that the transfer is paid-in surplus or a contribution to capital, the rules of section 1491 will be applicable. A taxpayer can avoid section 1491 through such strategies as electing to be taxed on the latent gain in the property transferred under section 1057; or the transferor may seek an *advance* ruling from the Service that the transfer is not for tax avoidance purposes. I.R.C. § 1492. *See* Alpert & Feingold, *Tax Reform Act Toughens Foreign Transfer Provisions of 1491 and Liberalizes 367,* 46 J. TAX. 2 (1977).

Note further that in any transfer subject to either general taxing rules or the specialized provisions of section 1491, the taxpayer cannot avoid tax by selling the technology for less than fair market value in a transfer, sale, or exchange which is not at arms length. The allocation rules of section 482 will adjust the transfer so that it will reflect "market realities."

[3] Section 367 was created by the Revenue Act of 1932 primarily to foreclose schemes designed to avoid taxation on the appreciation of capital assets. H.R. REP. No. 708, 72d Cong., 1st Sess. 20 (1932); S. REP. No. 665, 72d Cong., 1st Sess. 26-27 (1932). Prior to the Tax Reform Act of 1976, if a taxpayer sought to make a tax-free exchange (under sections 332, 351, 354, 356, or 361) involving a foreign corporation, he would be required, in most instances, to obtain *advance* approval from the Service. The taxpayer had the burden of demonstrating to the Service "that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." Int. Rev. Code of 1954, ch. 736, 68A Stat. 47, *as amended by* Pub. L. No. 91-681, § 1(a), 84 Stat. 2065 (current version at I.R.C. § 367(a)).

As often happens, the cure can be as distasteful as the disease. The principal problem arising under the above provisions was the hardship which resulted from forcing the taxpayer to await the decision of the Service before he could execute his exchange. If the Service gave an adverse ruling, the taxpayer would have to consider further delaying the transfer until litigation was completed. *See* JOINT COMMITTEE ON TAXATION GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 94th Cong., 2d Sess. 258, *reprinted in* 1976-3 (vol. 2) C.B., at 270 [hereinafter cited as JOINT COMMITTEE REPORT].

The new rules were thus designed to minimize notice requirements, and where notice is required to make notice procedures more palatable. The Amendments first draw the distinction between transfers into and out of the United States. Transfers out of the United States will still be required to obtain approval of the Service. The taxpayer must demonstrate to the satisfaction of the Service that the "exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." However, this determination need no longer be made in advance. The taxpayer need only file a request for a determination not later than the close of the 183rd day after the beginning of the transfer. I.R.C. § 367(a)(1). The Act also provides that the Secretary may designate certain out-bound transfers to be exempt from filing requirements, subject to any toll charges arising under section 367. I.R.C. § 367(a)(2). These exemptions from the clearance requirement are to be created for "outbound transfers where significant tax avoidance possibilities do not exist or where the amount of any 367 toll charge can be ascertained without a ruling request." S. REP. No. 94-938, 94th Cong. 2d Sess., at 265, *reprinted in* 1976-3 (Vol. 2) C.B., at 303. A toll charge is in essence an agreement to include in income certain of the items transferred.

> For example, if a section 351 Transfer to a foreign corporation involves only the transfer of cash and inventory property, the Secretary may by regulations designate the transaction as one which does not require the filing of a request, although the regulations would require the inventory to be taken into income.

JOINT COMM. REP. at 261, *reprinted in* 1976-3 (Vol. 2) C.B., at 273.

With respect to inbound transfers, no filing is required. Instead, these transfers will be judged according to regulations published by the Service. I.R.C. § 367(b).

To dissuade the Service from using section 367 as a broad sword to deny nonrecognition status to seemingly permissible potential nonrecognition exchanges, Congress expressly mandated judicial review of the Service's actions. Upon challenge, the Tax Court is to review both the Service's conclusion with respect to tax avoidance in general, as well as any specific conditions imposed by the Service in particular. JOINT COMM. REP. at 261, *reprinted in* 1976-3 (Vol. 2) C.B., at 273.

> The Tax Court is to review whether the Secretary's determination as to tax avoidance is reasonable and whether the conditions imposed in making the determinations are reasonable conditions in order to prevent the avoidance of income tax. If the Tax Court finds that the Secretary's terms and conditions are not reasonable, then the Tax Court is to make a declaration as to the terms and conditions which it finds to be reasonable in order to prevent the avoidance of income taxes.

JOINT COMM. REP. at 262, *reprinted in* 1976-3 (Vol. 2) C.B., at 274. With respect to inbound transfers the Report also states:

> These regulations are to be subject to normal court review as to whether the regulations are necessary or appropriate for the prevention of avoidance of Federal income taxes. Thus, a taxpayer may challenge a proposed deficiency with respect to an exchange dealt with in the regulations by arguing in the courts that the regulations, as applied in the taxpayer's case, are not necessary or appropriate to prevent the avoidance of federal income taxes.

JOINT COMM. REP. at 263-64, *reprinted in* 1976-3 (Vol. 2) C.B., at 275-76.

The Joint Committee emphasizes that section 367 rules are designated to prevent tax avoidance only, and should be applied only to the extent necessary to meet this objective. Although not meant to be exclusive, the committee provided examples of the ills which section 367 was designated to cure:

> Transactions in the first group [outbound transfers] generally include those transactions where the statutory aim is to prevent the removal of appreciated assets or inventory from U.S. tax jurisdiction prior to their sale, while transactions in the second group [inbound transfers] include those where the

language of section 351(a), not the added burden of section 367, which poses the real difficulties for a taxpayer transfering technology to a foreign subsidiary. The current language of section 351(a) generates numerous unanswered questions.[4] Specifically, what forms of technology represent qualifying "property"? What forms of technology are in essence services and thereby excepted from the concept of property by the "services" exclusion in the last sentence of section 351(a)? And finally, what forms of agreements will qualify as actual "transfers" of rights, rather than mere licensing arrangements? Without answers to these questions, a taxpayer must plan his international operations without the benefit of foreknowledge of the tax consequences of his decisions.[5]

> statutory purpose in most cases is to prepare for taxation the accumulated profits of controlled foreign corporations.

JOINT COMM. REP. at 260, *reprinted in* 1976-3 (Vol. 3) C.B., at 272. Presumably, if a transaction does not fit the mold of the prohibited avoidance schemes noted above, the Service cannot use section 367 to deny nonrecognition status to the transfer. Examples of items which the Service will not recognize as tax-free exchanges under section 351 can be found in *Guidelines regarding certain transactions involving foreign corporations requiring an advance ruling under section 367 of the Internal Revenue Code of 1954,* Rev. Proc. 68-23, 1968-1 C.B. 821, 823-25, § 3.02. For a discussion of the proposed regulations under section 367, see Arthur & Paisley, *Section 367: Working With the Temporary Regulations,* 4 INT'L TAX J. 859 (1978). For a review of the new rules under section 367 published prior to the issuance of the Service's proposed regulations on the subject, see Paisley, *Section 367—A Look at the Recent Amendments,* 4 INT'L TAX J. 692 (1977). Alpert & Feingold, *supra* note 2. For an analysis of the Guidelines under section 367, see, e.g., Sitrick, *Section 367 and Tax Avoidance: An Analysis of the Section 367 Guidelines,* 25 TAX L. REV. 429 (1970); Special Committee on Section 367 Policies, Tax Section, New York State Bar Ass'n, *Comments on Guidelines for Rulings under Section 367 Concerning Foreign Corporations,* 23 TAX LAWYER 151 (1969).

4 *See, e.g.,* Cohen, *Long-Awaited Ruling on Transfer of Know-How Sets Guidelines in Important Areas,* 21 J. TAX. 38 (1964); Flyer & Buell, *Tax-free Transfers of Computer Software to Foreign Corps: An Up-to-date Analysis,* 41 J. TAX. 26 (1974); Note, *Transfers of Technical Know-How to Controlled Foreign Corporations,* 5 VA. J. INT'L L. 81 (1964). *See also* Dunn, *The Transfer of Know-how to Controlled Corporations,* 39 TAXES 571 (1961), written prior to the issuance of Rev. Rul. 64-56. *See generally,* Dean, *Transfers to Controlled Corporations: Analyzing The Problem Areas,* 41 J. TAX 72 (1974); Goodman, *How to Avoid Tax Problems Under Section 351 When Transferring Services in Exchange for Stock,* 55 TAXES 112 (1977).

5 Some of the potential penalties of failing to qualify under section 351 are discussed in note 182 *infra.* Although perhaps less likely to occur in the context of foreign transactions, in some circumstances the taxpayer will purposely want to avoid the impact of section 351. *See, e.g.,* Fisher, *The Conversion of Ordinary Income to Capital Gain by Intentionally Avoiding Section 351 of the Internal Revenue Code,* 32 MO. L. REV. 421 (1967); Note, *Careful Tax Planning Avoid 351 for Stepped-Up Basis,* 27 J. TAX 20-21 (1967).

The taxpayer encounters the greatest difficulties when the "property" to be transferred consists wholly or predominantly of technical know-how. Very often, know-how consists of nothing more than information. It may or may not be secret; it may or may not be unique, novel, or original.[6] Very often the information transferred represents little more than accumulated experience, efficiencies, or skills that have been developed over time.[7] Certainly such information is valuable to both the transferor and the transferee.[8] But the test under section 351 is not explicitly one of "value"; it is one of "property."[9] What forms of valuable information can the taxpayer qualify as "property"? Moreover, even overcoming the property hurdle, what rights may the transferor retain in the transferred information while still complying with the transfer requirements under section 351?

This article will examine these questions. In so doing, the authors will attempt to provide clarity to current taxing rules which are at best ambiguous and at worst contradictory. The analysis which follows addresses three major questions: (1) For the purposes of know-how, how broadly have the words "property" and "services" been construed in past tax law decisions; (2) given the courts' treatment of these terms and in light of recent trade secret developments, what specific forms of know-how should qualify as "property" for the purposes of section 351; and, (3) assuming that the information qualifies as "property," what forms of transactions qualify as "transfers" for the purposes of section 351? In general the authors will attempt to highlight those instances where the Internal Revenue Service has misconstrued the letter and the spirit of the words "property," "services," and "transfer," the operative language of section 351.

I. "Property" and "Services" within Section 351

As the cynical observer might expect, the Internal Revenue Service has attempted to limit the term "property" to its narrowest construction, while broadening the concept of taxable services

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[6] *See* text accompanying notes 162-165 *infra*.

[7] *See* R. Milgrim, Trade Secrets § 2.09[3] (1977); Z. Cavitch, Business Organizations § 232.02[2] (1978); MacDonald, *Know-how Licensing and the Antitrust Laws*, 62 Mich. L. Rev. 351, 352-55 (1964); text accompanying notes 174-176 *infra*.

[8] *See* text accompanying notes 155-171 *infra*.

[9] The authors later argue that the concept of value and of property are nearly synonomous. *See, e.g.*, text accompanying notes 180-190 *infra*.

to its fullest sweep. The Service's basic approach to the analysis of know-how within the meaning of section 351 is set out in Revenue Ruling 64-56.[10] In this ruling, the Service conceded that items which constitute property in the hands of the transferor will qualify as "property" within section 351. "Once it is established that 'property' has been transferred, the transfer will be tax-free under section 351 even though services were used to produce the property."[11] This statement of course begs the question of what is and is not property. The Service also conceded that secret processes and secret formulas are property for the purposes of section 351.[12] However, as discussed below, there has never been a real dispute as to whether these most protected of trade secrets fall within section 351.[13]

Besides the statement that information "in the general nature of a patentable invention" will be property,[14] the Service provides little definition to the term "property" in the remainder of its ruling. The Service does note that, at a minimum, information must be secret and must receive "substantial" legal protection in order to qualify as a nonrecognition property transfer: "It is assumed for the purpose of this Revenue Ruling that the country in which the transferee is to operate affords to the transferor substantial legal protection against the unauthorized disclosure and use of the process, formula, or other secret information involved."[15] Significantly, however, the Service did not state that the presence in the transferee nation of legal protection is, in itself, sufficient to make secret information property for purposes of section 351. Thus, except for secret processes and secret formulas, the Service stands ready to challenge the "property" status of secret information—even if that knowledge is afforded legal protection as a valuable right: "Other information which is secret will be given consideration as 'property' on a case-by-case basis."[16]

Left without any real guidance as to what constitutes prop-

[10] 1964-1 (Part 1) C.B. 133.
[11] *Id.* at 134.
[12] *Id.*
[13] *See* text accompanying notes 44-52 *infra*.
[14] 1964-1 (Part 1) C.B. at 134.
[15] *Id.*
[16] *Id.*

erty, the taxpayer must cautiously analogize from the Service's list of forbidden services:

> (1) Training of the transferee's employees in various skills;
> (2) continued technical assistance after the start-up phase;
> (3) nonancillary assistance in the construction or layout of a plant, machinery, or equipment; and
> (4) other services performed for the transferee which are not merely ancillary or subsidiary to the transfer of property.[17]

This list of recognition transactions indicates that the Service intends to tax at ordinary income rates any transfer that can be catalogued as services to the transferee corporation. The only exception occurs when the services are merely "ancillary and subsidiary" to the transfer of property.[18] Since the term "property" is left substantially undefined, and since the Service intends to tax transfers of services, the taxpayer is forced to anticipate, without guidance, the expansiveness with which the Service intends to apply its definition of services.

Fortunately for the taxpayer, section 351 and the judicial decisions interpreting the statute demand a different analytical approach. From the historical analysis which follows, three basic conclusions emerge: (1) Despite a trend of Service rulings to the contrary, the term "property" is to be given its broadest definition;[19] (2) once transferred information is defined as "property," nonrecognition status is not lost merely because the transfer may be construed as providing services;[20] and, (3) even if the informa-

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[17] *Id.* at 134-35.

[18] *Id.* at 134.

[19] *See* E.I. DuPont de Nemours & Co. v. United States, 471 F.2d 1211, 1218 (Ct. Cl. 1973). *See also* J. BISCHEL, *supra* note 1, at ¶ 6.3; L. ECKSTROM, LICENSING IN FOREIGN AND DOMESTIC OPERATIONS ch. 4 (1977); R. MILGRIM, *supra* note 7, at ch. 1, 2, 6.4. In general, commentators have argued strenuously for the broadest possible definition of the word "property". *See generally* Dunn, *supra* note 4, at 572-73; Flyer & Buell, *supra* note 4, at 30; Nash, *The Concept of "Property" in Know-how as a Growing Area of Industrial Property: Its Sale and Licensing,* 6 PAT., T.M., & COPYRIGHT J. RESEARCH & EDUC. 289 (1962); O'Connor, *Tax Problems on Transfers of Assets to Corporations,* 52 TAXES 756, 758 (1974). For a detailed discussion of this issue, see notes 25-42 and accompanying text *infra.*

[20] *See* Howard S. Gable, 33 T.C.M. (CCH) 1427, 1431-33 (1974); Rev. Rul. 56, 64-1 C.B. 133. *See also* Burke, *Section 351: The Beginning of Life in Subchapter C,* 24 Sw. L.J. 742, 747-56 (1970); Cohen, *supra* note 4; Duffy, *Doing Business Abroad: Use of American Know-How,* 20 N.Y.U. INST. FED. TAX. 1269, 1269-73, 1299-1300 (1962); Dunn, *supra* note 4, at 572-575 (1961); Riebesehl, *Tax Free Incorporations Under Section 351,* 46 TAXES 360, 361-62 (1968); Weiss, *Problems in the Tax-Free Incorporation of a Business,* 41 IND. L.J. 666, 668-670 (1966). For a detailed discussion of this services issue, see notes 30-31, 62-63 and 73-103 and accompanying text *infra.*

tion is in fact services, and not a transfer of property, there will be no adverse tax consequences to the transferor as long as the services are an "incident of" or related to, the transfer of property.[21] In general, the term "services" is to be given its narrowest definition and its most limited impact.[22]

With respect to transfers of know-how, the effect of this conclusion is dramatic. Both the Service and the courts recognize that know-how can be "property" within section 351. Nevertheless, a transfer of know-how in gross, *i.e.* unaccompanied by a transfer of patents, secret processes, or secret formulas, can almost always be construed as little more than the performance of services.[23] Consequently, under the Service's guidelines as formu-

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[21] *See* Howard S. Gable, 33 T.C.M. (CCH) 1427, 1431-33 (1974); Bell Intercontinental Corp. v. United States, 381 F.2d 1004, 1020 (Ct. Cl. 1967); Heil Co., 38 T.C. 989, 1003 (1962). Until recently the commentators have focused almost exclusively on the Service's "ancillary and subsidiary to" language. *See generally* Burke, *supra* note 20, at 747-56; Campbell, *Increasing Profits From Foreign Know-How Licensing,* 45 DEN. L.J. 31, 32-34 (1968); Cohen, *supra* note 4, at 38-40; Duffy, *supra* note 20, at 1270-73, 1299-1300; Flyer and Buell, *supra* note 4, at 29-30; Ladas, *Legal Protection of Know-How,* 7 PAT., T.M., & COPYRIGHT J. RESEARCH & EDUC. 397, 401 (1963); Riebesehl, *supra* note 20, at 361-62; Weiss *supra* note 20 at 668-69. For a detailed discussion of this issue, see notes 56-59, 67-104 and accompanying text *infra.*

[22] *See generally* Note, *Does IRS "Sale or Exchange" Theory Under 351 in Recent Ruling Go Too Far?,* 31 J. TAX. 53, 54 (1969) (The author states that section 351 contains no definition of property. "Services" are excluded under section 351(a) and such a singular and extraordinary exception denotes the only exception to the term "property" under the rule of statutory construction—*expressio unius est exclusio alterius* (expression of one thing is exclusion of another).) *See also* Cohen, *supra* note 4, at 39, where the author notes that the Service's exclusion from property status of information developed for the transferee under section 351 should be construed narrowly, distinguishing the production of information specifically for the transferee from those instances where the transferee benefits only indirectly from the transferor's general research. *See also* notes 67-103 and accompanying text *infra.*

[23] *See generally* Howard S. Gable, 33 T.C.M. (CCH) 1427, 1433 (1974) (in the sale of technical information the buyer is likely to require technical assistance); United States Mineral Prod. Co., 52 T.C. 177, 199 (1969) (assuming arguendo that technical information constituted consulting services). *See also* Cooper, *Tax Aspects of Corporate Exploitation of Inventions and Know How,* 38 So. CAL. L. REV. 206, 206-07 (1965) (know-how is the method of achieving a result); Creed and Bangs, *Know-How" Licensing and Capital Gains,* 4 PAT., T.M., & COPYRIGHT J. RESEARCH & EDUC. 93, 93 (1960) (know-how may involve accumulated technical experience and skills which can best, or perhaps only, be communicated through the medium of personal services); Duffy, *supra* note 20, at 1269-73, 1299-1300 (know-how is inherently a personal attribute, an idea, or a skill, i.e., training and experience); Flyer and Buell, *supra* note 4 (though there are tangible items in trade secrets, technical knowledge is the primary value); Ladas, *supra* note 21 (know-how pertains to the method of achieving a result). For a detailed discussion of this issue, see notes 56-59 and 67-104 and accompanying text *infra.*

lated in Revenue Ruling 64-56, and under even stricter interpretations which followed, a taxpayer must question if the transfer of know-how in gross may ever qualify as a transfer of property if the Service meticulously and mechanically applies its stated standards.[24] However, by broadly defining "property" and by limiting the impact of the services exception, one reaches the opposite conclusion, that the transfer of know-how in gross will qualify as a transfer of property, at least to the extent that the information is generally recognized as a legal protected interest.

A. *The Historically Broad Approach to Section 351*

One source of support for a broad interpretation of the term "property" as used in section 351 may be found in the legislative history behind section 202(c)(3) of the Revenue Act of 1921, the predecessor of section 351(a).[25] In a noteworthy passage from the Senate Report, the purpose of section 202(c)(3) was succinctly stated: The statute fashions new rules of nonrecognition "for those exchanges or *'trades'* in which, although a technical 'gain' may be realized . . . the taxpayer actually realizes no cash profit."[26] Further supporting the Senate Report's interpretation

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[24] Rev. Rul. 56, 1964-1 C.B. 133. For subsequent interpretations and applications of this ruling, see Rev. Proc. 36, 1974-2 C.B. 491 (Rev. Proc. 69-19 is applicable to § 367 rulings on computer software); Rev. Proc. 10, 1973-1 C.B. 760, (general requirements for a ruling under section 351) *superseding* Rev. Proc. 17, 1970-2 C.B. 490; Rev. Rul. 564, 1971-2 C.B. 179 (transfers of trade secrets under section 351 must be exclusive for the entire period prior to the secret's becoming public knowledge); Rev. Proc. 17, 1970-2 C.B. 490; Rev. Proc. 19, 1969-2 C.B. 301 (conditions for a § 367 ruling as to transfers of know-how); Rev. Rul. 156, 1969-1 C.B. 101 (must grant all substantial rights to a sale or exchange of a patent to qualify under § 351). The Service's position prior to Rev. Rul. 64-56 may be found in Rev. Rul. 17, 1955-1 C.B. 388 where the Service ruled that payments for know-how and technical assistance transferred to a foreign corporation constituted royalty income. It is critical to note that the Service specifically found that the services had only nominal value apart from the license to use the know-how. For a detailed discussion of these rulings, in particular Rev. Rul. 64-56 and Rev. Proc. 69-19, see notes 60-67, 121-181 and accompanying text *infra*.

[25] *See* Revenue Act of 1921, ch. 136, § 202(c)(3), 42 Stat. 230 (1921) (current version at I.R.C. § 351(a)). The statute stated: "For the purposes of this title, on an exchange of property, real, personal or mixed . . . no gain or loss shall be recognized . . . (3) when (A) a person transfers any property . . . to a corporation, and immediately after the transfer is in control of such corporation."

[26] *See* S. REP. No. 275, 67th Cong., 1st Sess. 11 (1921). The language of the Senate Report has subsequently been cited with approval in E.I. DuPont de Nemours & Co. v. United States, 471 F.2d 1211, 1215 (Ct. Cl. 1973); Halliburton v. Comm'r, 78 F.2d 265, 269 (9th Cir. 1935); Ralph L. Evans, 8 B.T.A. 543, 546 (1927). *See also* Comment, *Analysis of Revenue Ruling 75-292*, 17 WM. & MARY L. REV. 599, 611 (1976) (a brief discussion of Senate Report 275).

of the new statute, the Hearings before the Senate Finance Committee emphasized that new section 202(c)(3) was aimed at disregarding *merely formal* dispositions that lacked economic or commercial reality.[27] Finally, and perhaps of greatest importance, the Hearings Explanation on the subsequent amendments to section 202 in the Revenue Act of 1924 emphasized that section 202(c)(3) transactions involved no substantial change in ownership, and thus no gain or loss was to be realized until an event equivalent to a sale or exchange occurred.[28] In summary, the historical development of section 202(c)(3) and its successors indicates a legislative concern that lest purely formal and internal corporate rearrangements be impeded, a taxpayer should not be forced to recognize gain or loss when in practical effect he is merely transferring property to himself.

It was not until the passage of the 1954 Internal Revenue Code that Congress added the final sentence of section 351(a), precluding the recognition of services as property.[29] The accom-

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[27] *See Hearings Explanation of 202(c) Before the Senate Finance Committee*, 67th Cong., 1st Sess. 27, 30 (1921). Language similar to that found in the Hearings has appeared in numerous cases. *See, e.g.*, Helvering v. Cement Investors, Inc., 361 U.S. 527, 533 (1941) (section 202(c)(3) designed to permit readjustments); Six Seam Co. v. United States, 524 F.2d 347, 355 (6th Cir. 1975) (aimed at technical transfers only—internal rearrangements); E.I. DuPont de Nemours & Co. v. United States, 471 F.2d 1211, 1213-15 (Ct. Cl. 1973) (aimed at mere form exchanges); Jordan Marsh Co. v. Comm'r, 269 F.2d 452, 457 (2d Cir. 1959) (citing *Portland* and *Trenton*); Barker v. United States, 200 F.2d 223, 228 (9th Cir. 1953) (citing the language in *Portland*); Trenton Cotton Oil Co. v. Comm'r, 147 F.2d 33, 36 (6th Cir. 1945) (citing the *Portland* "mere change in form" language); Portland Oil Co. v. Comm'r, 109 F.2d 479, 488 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940) (where in a popular or economic sense there has been a mere change in the form of ownership); American Compress & Warehouse Co. v. Bender, 70 F.2d 655, 657 (5th Cir.), *cert. denied*, 293 U.S. 607 (1934).

[28] *See* S. REP. No. 398, 68th Cong., 1st Sess. 278 (1924); H.R. REP. No. 179, 68th Cong., 1st Sess. 12 (1924). For further discussion of these Reports, see Comment, *supra* note 26, at 611. *See also* Magill, *Notes on the Revenue Act of 1924 - Income Tax Provisions*, 24 COLUM. L. REV. 836, 841-44 (1924) for a brief review of the 1924 Act's amendments and changes.

As noted above in Comment, *supra* note 26, at 612: "[The] same principle recurs throughout the congressional hearings, debates, and committee reports pertaining to the 1934 amendments, which hold that purely formal 'paper' transactions . . . result in no immediate tax consequences." *See, e.g.*, S. REP. No. 558, 73d Cong. 2d Sess. (1934); H.R. REP. No. 704, 73d Cong., 2d Sess. 13 (1934); *Hearings on Revenue Revision Before the House Ways and Means Committee*, 73d Cong., 2d Sess. 58, 77, 290-91 (1934).

[29] I.R.C. § 351(a) provides that: "For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property." *See also* Treas. Reg. § 1.351.1(a)(1)(i) which states that: "[S]tock or securities issued for services rendered or to be rendered to or for the benefit of the issuing corporation will not be treated as having been issued in return for property . . . ."

panying House Report indicates that the exclusion of services from the definition of property was designed to make the receipt of stock or securities by a transferor who has rendered, or will render, services to the transferee corporation, a fully taxable event.[30] The Report does contain a caveat, however, which states that the committee did not intend the last sentence of section 351(a), the services exclusion, to vitiate the remaining portion of the transaction;[31] bona fide transfers of property were to remain non-tax recognition events.

In contrast to the legislative history behind many other provisions of the Code, the legislative history behind section 351 has played an integral role both in the interpretation of the specific statutory language and the development of a uniformly liberal response to the general purpose underlying the statute. For example, one court has managed to turn the services exclusion in section 351(a) into a basis of support for recognition of a broad definition of the word "property." In *H.B. Zachary Co.*, the Tax Court observed that the known inclusions and exclusions under section 351 (implicitly referring to the services exception) strongly suggested that property encompasses whatever may be

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[30] *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954), *reprinted in* U.S. CODE CONG. & AD. NEWS 4017, 4254-56.

[31] *Id.* at 4255. The language of House Report 1337 has served as support for numerous attempts by various authors to limit the scope of the services exception. *See, e.g., Burke, supra* note 20, at 750 (distinguishing services to the transferee, services for third parties, and property created by personal services); Cohen, *supra* note 4, at 39 (services for the transferee should be strictly construed); Goodman, *supra* note 4, at 113. (citing the language of House Report 1337); Riebesehl, *supra* note 20, at 362; Weiss, *supra* note 20, at 668-670; Note, *Income Tax - Tax Free Transfers to Controlled Corporations*, 76 W. VA. L. REV. 401, 404 (1973-74). Numerous judicial decisions have emphasized that "services *for* the transferee" are the main thrust of the exclusion under § 351. *See, e.g.*, Howard S. Gable, 33 T.C.M. (CCH) 1427, 1433-34 (1974) (distinguished nontaxable related services from services rendered to the transferee to create or develop an invention); William A. James, 53 T.C. 63, 67 (1969) (citing House Report 1337); Elihu B. Washburne, 27 T.C.M. (CCH) 577, 591 (1968) (stock issued for the obtaining of an option was issued for services rendered the transferee); Arthur C. Ruge, 26 T.C. 138, 142-43 (1956) (citing *Kimble Glass*, a transferor's obligation to (1) further develop his invention, (2) disclose future inventions to the transferee, and (3) keep the transferee informed of developments in the field were unrelated to the products transferred and therefore were compensable services); Kimble Glass Co., 9 T.C. 183 (1947) (see analysis in *Ruge*, 26 T.C. at 142-43). For further discussion of the "services as property" concept, see notes 63-104 and accompanying text *infra*.

In Rev. Proc. 19, 1969-2 C.B. 301, Rev. Rul. 56, 1964-1 C.B. 133 and Treas. Reg. § 1.351-1(a)(1)(ii) (1954), the Service formally announced its position that services other than "ancillary and subsidiary to" services rendered to the transferee are not property within the scope of section 351.

transferred.[32] Based upon this assertion, the court went one step further and, applying the doctrine of *expressio unius est exclusio alterius* to section 351(a), held that the services exception was the only statutorily supported exclusion to the otherwise broad and general meaning of the term "property."[33]

The court's conclusion in *H.B. Zachary Co.* that "property" is to be given its broadest definition received recognition and support in the 1973 Court of Claims decision, *E.I. DuPont de Nemours & Co. v. United States*.[34] In 1959, the Du Pont Company granted its wholly-owned French subsidiary a royalty-free nonexclusive license to make, use, and sell a patented herbicide formula within the geographic bounds of France. Rejecting the Service's argument which was based upon an unfounded analogy between the word "transfer" in section 1235 and the phrase "transfer . . . in exchange" found in section 351(a), the Court of Claims held that: "[U]nless there is some special reason intrinsic to the particular provision (as there is with respect to the capital gains provisions) the general word 'property' has a broad reach in tax law . . . . For section 351, . . . courts have advocated a generous definition of property . . . ."[35] In an attempt to fashion guidelines delimiting the breadth of this seemingly boundless language, the court emphasized that in this transaction the nonexclusive license itself was commonly thought of in the commercial world as a "positive business asset."[36] *DuPont's* reference to a "positive business asset" test for property is peculiarly well-suited to the analysis of issues involving the transfer of nonpatented and nonpatentable technology, rights often de-

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[32] 49 T.C. 73, 80 n.6 (1967).

[33] *Id.* The *expressio unius est exclusio alterius* argument has been echoed in Note, note 22 *supra;* Note, *Carved Out Oil Payment Constitutes Property For Section 351 Purposes,* 17 OIL & GAS Q. 69, 73-4 (1968). The *Zachary* decision is weakened however by its failure to address the crucial issue; admitting that services are excluded from the definition of "property," what constitutes services?

[34] 471 F.2d 1211 (Ct. Cl. 1973).

[35] *Id.* at 1218. The Service argued that section 1235 (I.R.C. § 1235) which outlines the necessary elements for a patent "transfer" to qualify as a capital asset exchange, also governed the meaning of the words "transfer" and "exchange" under section 351. *Id.* at 1215-18. After rejecting the Service's argument, the court examined the scope of the word "property" only for purposes of section 351. *Id.* at 1218. The *DuPont* rejection of this section 351—section 1235 analogy is discussed in detail in notes 223-229 and accompanying text *infra.*

[36] *Id.*

fined in terms of the "competitive advantage" accruing to their possessor.[37]

Comparably broad language with respect to intangible rights and assets may be found interspersed throughout much of the applicable case law.[38] Citing with approval the *DuPont* decision, the District Court for the Middle District of Georgia, in *Stafford v. United States*,[39] held that, with respect to a lease and loan agreement at interest rates below the market rate, property for purposes of section 351 included any real, personal, tangible, or

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[37] For a discussion of the "competitive advantage" and the "positive business asset" test in trade secret law, see notes 115-190 and accompanying text *infra*. Applying the "positive business asset" test, the *DuPont* court noted: "DuPont handed over something of value and received stock in return . . . ." 471 F.2d at 1219.

[38] The breadth of the *DuPont* property definition is shocking at first glance; nevertheless, *DuPont* is not an isolated or single instance of such liberality. Numerous decisions have espoused a similar test. *See, e.g.*, Max A. Burde, 43 T.C. 252, 269 (1964), *aff'd*, 352 F.2d 995 (2d Cir. 1965), *cert. denied*, 383 U.S. 966 (1966) (property right in an invention comes into existence when it is reduced to actual practice—tested and operated successfully); E.I. DuPont de Nemours & Co. v. United States, 288 F.2d 904, 911 (Ct. Cl. 1961) (a trade secret is property because it conveys more than mere information; it confers an economic advantage); Nelson v. Comm'r, 203 F.2d 1, 6 (6th Cir. 1953) (secret process that was valuable and reduced to tangible form constituted property); Halliburton v. Comm'r, 78 F.2d 265, 269 (9th Cir. 1935) (the word "property" is used without qualification in section 202(c)(3)); George S. Mepham, 3 B.T.A. 549, 553 (1926) (a secret process is property where it is secret, valuable, and successful); Chrome Plate, Inc., 40 AM. FED. TAX. REP. 2d (PH) ¶ 77-5316, 6125 (W.D. Tex. 1977) (citing *DuPont* and *Hempt*, the court held that property should be defined as broadly as possible); Hempt Bros., Inc. v. United States, 354 F. Supp. 1172, 1175 (M.D. Pa. 1973), *aff'd*, 490 F.2d 1172 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974) (property is whatever may be transferred).

See also Duffy, *supra* note 20, at 1270-71 (citing Crane v. Comm'r, 331 U.S. 1 (1947) for the proposition that property is everything that is the subject of ownership); Dunn, *supra* note 4, at 572 (most, if not all, types of know-how constitute property); Ladas, *supra* note 21, at 397-409; O'Connor, *supra* note 19, at 758 (citing the 1973 *DuPont* decision, the author suggests that there is no reason to restrict the definition of property); Riebesehl, *supra* note 20, at 361-62 (trade secrets and patents will ordinarily constitute property, but the secrecy requirement of Rev. Rul. 64-56 is subject to attack); Note, *supra* note 33, at 54 (citing the language of *Zachary* that property is anything that may be transferred). All of the authors have advocated a broad meaning for the word property in an attempt to bring at least trade secrets, if not all that is encompassed under the rubric of know-how, within the scope of section 351.

[39] 435 F. Supp. 1036, 1038 (M.D. Ga. 1977). Interestingly, the Government raised the argument that the agreement between the parties did not constitute a legally enforceable contract and therefore could not constitute "property." In perhaps the most sweeping dicta to date, the court rejected the Government's position stating that the enforceability of the agreement was irrelevant; the parties, believing they were bound, did in fact perform. *Id.* at 1038-39. This language extends beyond even the *DuPont*, 471 F.2d at 1218-19, and *Zachary*, 49 T.C. at 79-80, tests that previously applied only to legally enforceable agreements, i.e., a nonexclusive license of a patent and a royalty agreement, respectively.

intangible rights which the owner thereof could possess, use, or dispose of. Definitions of equivalent breadth may also be found in *Commissioner v. Stephens-Adamson Manufacturing Co.*[40] and *H.B. Zachary Co.*,[41] where the courts held that whatever may be transferred constitutes property. *Hempt Brothers, Inc. v. United States*, a 1974 Third Circuit Court of Appeals decision, has held similarly that property consists of whatever may be sold or assigned.[42] Notwithstanding such generous language, any attempt to analyze the scope of the word "property" for purposes of section 351(a) merely by examining the dicta of past decisions will be misleading. Often, the courts have been more sweeping in their analyses and conclusions than required by the specific factual setting before them.

B. *The Development From Secret Formulas to Know-How*

Despite the plethora of section 351 property cases before the courts in the last fifty years, the body of law concerning trade secrets and know-how under section 351 (in contrast to that concerning patents) has been slow to develop. Both the courts and the Service have struggled to define these intangible rights, as well as to outline the proper tax treatment of their transfers.[43]

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[40] 51 F.2d 681, 683 (7th Cir. 1931) (For purposes of determining the scope of section 202(a) of the Revenue Acts of 1918 and 1921: "We think it a fair definition to say that what may be sold and assigned is property.")

[41] 49 T.C. 73, 80 n.6 (1967) ("Section 351 does not contain a definition of the word 'property.' However, the known inclusions and exclusions strongly suggest that the term encompasses whatever may be transferred.") *See also* notes 32-33 and accompanying text *supra*.

[42] 354 F. Supp. 1172 (M.D. Pa. 1973), *modified*, 490 F.2d 1172, 1175 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974). The court specifically stated that for purposes of section 351, property is whatever may be identified, valued, and transferred. Such language, however, adds little to the lower court's formulation of the test: "Whatever may be transferred." 354 F. Supp. at 1175. Again, the breadth of the *Hempt* test is tempered by the very traditional nature of the property involved, accounts receivables. *Compare* Chrome Plate, Inc., 40 AM. FED. TAX REP. 2d (PH) ¶ 77-5316, 6125 (W.D. Tex. 1977) where the court relied upon *Hempt Bros.* and *DuPont* to support the broad assertion that for purposes of section 351 the courts were unanimous in holding that property should be contrued as broadly as possible. *See also* O'Connor, *supra*, note 19 at 758, where the author argues that there is a strong statutory basis for the *DuPont-Hempt Bros-Chrome Plate* line of developments.

[43] *See* notes 44-104 and accompanying text *infra* for a discussion of the tax developments in the know-how area. The phrase "know-how" appears to be a phenomenon of the last twenty years. As demonstrated by notes 44-52 and accompanying text *infra*, the decisions prior to Rev. Rul. 56, 1964-1 C.B. 133 focused primarily on secret processes and formulas, not know-how. There simply is no use of the phrase "know-how" in the tax law

Focusing more specifically on trade secrets and know-how transfers under section 351(a), the Service and the courts have been most favorable to the transfer of secret formulas[44] and secret processes. As early as 1927, relying on the legislative history of sec-

until the Service ruled that certain techniques and methods constituted know-how in 1955. See Rev. Rul. 17, 1955-1 C.B. 388. Beginning with Heil Co., 38 T.C. 989 (1962), "know-how" has become a common phrase in the tax decisions. Unfortunately, "know-how" has still not been defined with any specificity. It is the premise of this article that the RESTATEMENT OF TORTS § 757 has implicitly been adopted by the Supreme Court as a definition of the broad term "trade secrets." *See* the discussion at notes 105-121 and accompanying text *infra*. The definition of "trade secret" found in the Restatement appears broad enough to include know-how. Numerous commentators have attempted to fashion a definition of "know-how." *See, e.g.*, Creed and Bangs, *supra* note 23, at 93; Duffy, *supra* note 20, at 1269-73, 1299-1300; Dunn, *supra* note 4, at 572; Nash, *supra* note 19, at 289; Van Notten, *Know-How Licensing in the Common Market*, 38 N.Y.U.L. REV. 525, 526-27 (1963). *See also* BISCHEL, *supra* note 1, at 6-6 to 6-14.

In 1964, nine years after the Service first addressed the issue of know-how in Rev. Rul. 17, 1955-1 C.B. 388, the Service was still uncertain of what know-how meant. See Rev. Rul. 56, 1964-1 C.B. 133 where the Service ruled that: "Since the term 'know-how' does not appear in section 351 of the Code, its meaning is immaterial . . . the Service will look behind the term . . . to determine . . . if . . . the terms . . . constitute property . . . ." In sharp contrast to the Service's inability to define "know-how" in 1964 is Treas. Reg. § 1.482-2(d)(3) where the Service for purposes only of proper allocation of income and deductions among related taxpayers defined intangible property as "(a) Patents, inventions, formulas, processes, designs, patterns . . . . (e) *Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data,* and *other similar items.*" (Emphasis added.)

[44] *See* Edward W. Reid, 50 T.C. 33, 41 (1968) (secret formula constituted property); Pickren v. United States, 378 F.2d 595, 599-601 (5th Cir. 1967) (secret formulas were capital assets under § 1235); Commercial Solvents Corp., 42 T.C. 455, 467 (1964) (a secret process is a capital asset as well as property); E.I. DuPont de Nemours & Co. v. United States, 288 F.2d 904, 910 (Ct. Cl. 1961) (Government conceded that secret processes constituted property); Nelson v. Comm'r 203 F.2d 1, 6 (6th Cir. 1953) (secret processes may constitute property); Ruth Neuberger v. United States, 69-1 U.S. Tax Cas. ¶ 9264, 84166 (D. Ore. 1968) (secret formulas are property); Stalker Corp. v. United States, 209 F. Supp. 30, 33-34 (E.D. Mich. 1962) (trade secrets constitute property); Huckins v. United States, 60-1 U.S. Tax Cas. ¶ 9394, 76091-92 (S.D. Fla. 1960) (secret process treated as a capital asset under section 1221).

For further recognition of secret formulas as property, see generally Benjamin, *Tax Aspects of Operating a Possession Corporation in Puerto Rico*, 2 INT'L TAX. J. 197, 200-01 (1976); Cohen, *supra* note 4, at 38; Dunn, *supra* note 4, at 572 n.2; Hilinski, *Is the IRS Blocking the Tax-Free Transfer of Know-How to Foreign Corporations?*, 23 J. TAX. 305, 305-06 (1965); Nash, *supra* note 19, at 94-99; Riebesehl, *supra* note 20, at 361-62.

The Service, since 1964, has officially recognized that secret formulas constitute property for purposes of section 351. *See, e.g.*, Rev. Rul. 564, 1971-2 C.B. 179 (trade secret remains valuable and therefore constitutes property only so long as it remains a secret); Rev. Proc. 19, 1969-2 C.B. 301, (the Service requires that the taxpayer represent that the information he seeks to transfer pursuant to sections 351 and 367 is secret, known only by certain confidential employees, and is adequately safeguarded); Rev. Rul. 56, 1964-1 C.B. 133 (property for purposes of section 351 includes secret processes and formulas).

tion 202(c)(3), the Board of Tax Appeals, in *Ralph L. Evans,* held that a corporate transfer of a secret hair-dye formula constituted property for purposes of section 202(c)(3).[45] One year earlier, in *George S. Mepham,* the Board had accorded capital asset status to (and ultimately capital gains treatment to the sale of) a secret fume-trapping process.[46] Again in 1948, the Tax Court, in *Wall Products, Inc.,*[47] advanced the burgeoning analysis one step fur-

[45] 8 B.T.A. 543 (1927). The Board succinctly disposed of the issue as to whether or not the secret formula constituted property by the overly simplistic statement: "It is admitted that he transferred the secret process to the Delaware corporation." *Id.* at 547. *See also* William A. James, 53 T.C. 63, 68-69 (1969) where, based on *Evans,* the court recognized that secret formulas constituted property for purposes of section 351, but held such analysis inapposite to the transfer of purely services. The *Evans* decision was subsequently cited by the Service in Rev. Rul. 56, 1964-1 C.B. 133, 134, to support the Service's acquiescence as to secret processes and formulas. *Evans* was also subsequently interpreted more broadly than its language might support when Flyer and Buell noted that both *Evans* and Wall Products, Inc., 11 T.C. 51 (1948) are framed in terms of trade secrets generally being property. Flyer and Buell, *supra* note 4, at 27 n.14. This analysis may be questionable in light of the fact that both decisions dealt explicitly with secret formulas only. *See also* notes 46 and 47 *infra,* and note 44 *supra.*

[46] 3 B.T.A. 549, 553 (1926). The Board emphasized three factors: The process (1) was clearly secret, (2) had proven to be successful, and (3) was never patented. *Id. Mepham* was subsequently cited as support for the broad statement in United States Mineral Prod. Co., 52 T.C. 177, 196-97 (1969), that the courts have long recognized industrial knowledge and secret formulas, reduced to practice, as property. Although *Mepham* has been cited in the case law only infrequently, it has received wide recognition in the legal literature. *See, e.g.,* Cooper, *How a Corporation Can Get Capital Gains When Licensing Inventions and Know-How,* 24 J. TAX. 334, 334-35 (1966) (*Mepham* held a secret manufacturing process to be intangible property); Duffy, *supra* note 20, at 1271 n.7; Sugarman, *Incorporating Tax Free - Basic Requirements Under Section 351 of the Internal Revenue Code,* 12 CASE W. RES. L. REV. 183, 186 (1961) (*Mepham* cited for the broad proposition that goodwill, know-how, and trade secrets qualify as property under section 351).

[47] 11 T.C. 51, 57 (1948). The specific product involved was a highly successful concrete-curing formula. *Id.* at 52-55. The court observed that without the inventor's technical skills, manufacture of the product would have been impossible. *Id.* at 54. Recognizing that a secret formula may constitute property, the court rejected the Service's argument that application for a patent was a requisite element to a finding of property status. *Id.* at 57. Subsequent attempts by the Service to make property status contingent on the existence of a patent application have also been rebuffed. *See, e.g.,* Max A. Burde, 43 T.C. 252, 269 (1964) *aff'd,* 352 F.2d 995 (2d Cir. 1965), *cert. denied,* 383 U.S. 966 (1966); Franklin S. Speicher, 28 T.C. 938, 944-45 (1957); Samuel E. Diescher, 36 B.T.A. 732, 743-44 (1937), *aff'd,* 110 F.2d 90 (3d Cir.), *cert. denied,* 310 U.S. 650 (1940); Comm'r v. Stephens-Adamson Mfg. Co., 51 F.2d 681, 683 (1931). Similarly to *Evans,* (see discussion in note 45 *supra*) *Wall Prod.* was cited with approval in Rev. Rul. 56, 1964-1 C.B. 133, 134. It is interesting to note that in United States Mineral Prod. Co., 52 T.C. at 197, *Mepham* was distinguished from *Wall Prod.* on the grounds that the former was an industrial knowledge case, while the latter was purely a secret formula decision. *Compare also* Cooper, *supra,* note 46, at 335, (*Wall Prod.* recognized that a secret formula may constitute property) and Duffy, *supra* note 20, at 1271 n.7 (*Wall Prod.* held a secret

ther, holding that the property right in a patentable, but as yet unpatented, secret formula was not negatived by a failure to file a patent application. Finally, in 1961, in *E.I. DuPont de Nemours and Co. v. United States,* the Service conceded that the transfer of a secret process constituted the transfer of property.[48]

In light of the Government's concession in *DuPont,* it came as little surprise in Revenue Ruling 64-56[49] that the Service ruled property to include such items as secret processes, secret formulas, and secret information concerning devices or processes without regard to the existence of a patent or the patentability of the asset in question.[50] Again the Service's concession as to un-

formula to be property), *with* Flyer and Buell, *supra* note 4, at 27 n.14, where the authors interpreted *Wall Prod.* as applicable to the broader field of trade secrets as defined by the RESTATEMENT OF TORTS § 757 (1939). *Id.* at 28-29.

[48] 288 F.2d 904, 910 (Ct. Cl. 1961). Despite the Service's recognition that secret formulas constituted property, the taxpayer failed to meet the "sale or exchange" requirement of sections 117, 1221, and 1231. *Id.* at 906-909. For further discussion of what constitutes a "transfer" under section 351, see notes 197-241 and accompanying text *infra.* The decision in the 1961 *DuPont* case has subsequently served as the foundation for any extension of the property concept to include know-how and trade secrets related to transferred patents. *See, e.g.,* E.I. DuPont de Nemours & Co. v. United States, 471 F.2d 1211, 1215-20 (Ct. Cl. 1973); Francis H. Shepard, 57 T.C. 600, 611-18 (1972), *rev'd,* 481 F.2d 1399 (3d Cir. 1973) (unpublished opinion), *cert. denied,* 417 U.S. 911 (1974); Taylor-Winfield Corp., 57 T.C. 205, 214 (1971); PPG Indus., Inc., 55 T.C. 928 (1970); United States Mineral Prod. Co. 52 T.C. 177, 199 (1969); Commercial Solvents Corp. 42 T.C. 455 468 (1964); Pickren v. United States, 249 F. Supp. 560, 561 (M.D. Fla. 1965), *aff'd,* 378 F.2d 595 (5th Cir. 1967); Stalker Corp. v. United States, 209 F. Supp. 30, 33 (E.D. Mich. 1962); Rev. Rul. 564, 1971-2 C.B. 179, all know-how decisions citing the 1961 *DuPont* decision.

[49] Rev. Rul. 56, 1964-1 C.B. 133.

[50] *Id.* at 134-35. In summary the Service ruled that "The term 'property' for purposes of section 351 of the Code will be held to include anything qualifying as 'secret processes and formulas' . . . and any other secret information as to a device, process, etc., in the general nature of a patentable invention without regard to whether a patent has been applied for . . . and without regard to whether it is patentable in the patent law sense . . . ." The Service, in Rev. Proc. 19, 1969-2 C.B. 301, 302, subsequently defined secret information as that information "known only by the owner and those confidential employees who require the 'information' . . . and adequate safeguards have been taken to guard . . . against unauthorized disclosure, and (b) . . . the 'information is original, unique, and novel." To date, only Howard S. Gable, 33 T.C.M. (CCH) 1427, 1433 n.3 (1974); William A. James, 53 T.C. 63, 68 (1969); and Bell Intercontinental Corp. v. United States, 381 F.2d 1004, 1020 (Ct. Cl. 1967) have even mentioned Rev. Rul. 64-56 expressly; to date no court has cited Rev. Proc. 69-19. For further discussion of the "absolute secrecy" versus the "relative secrecy" doctrines, see notes 122-154 and accompanying text *infra.*

Numerous tax commentators have also questioned the need for an "absolute secrecy" doctrine. *See, e.g.,* Benjamin, *supra* note 44, at 201 (contrasting Rev. Proc. 69-19, with the language of *DuPont,* 471 F.2d at 1218); Cohen, *supra* note 4, at 38 (secrecy is questionable in light of the 1961 *DuPont* decision, 288 F.2d at 910-12); Duffy, *supra* note 19, at patented secret devices or processes, in addition to secret formulas, was merely the formal recognition of an already clear line of judicial developments. Therefore, the Service's seemingly broad concession on the patentability issue was less an act of spontaneous generosity and more an official recognition of a demonstrated judicial receptiveness toward transfers of such items. For example, in 1940, in *Samuel E. Diescher*, the Third Circuit Court of Appeals held that an inventor's property right in his invention was not dependent upon his obtaining a patent, but rather existed as a result of his reduction of the invention to practice.[51] Seventeen years later in *F.S. Speicher*, the Tax Court stated that the unpatented inventions in question constituted property, for the transferor had a completed conception of his invention and had previously expressed it in the form of drawings and a physical machine.[52] In retrospect, there has been little if any resistance to the recognition of unpatented secret formulas and secret devices as property for purposes of section 351(a).

The courts, however, have yet to address the issue of what

1271-72 (secrecy alone should not be the test for whether an asset constitutes property); Riebesehl, *supra* note 20, at 362 (whether secrecy should be an element at all); Weiss, *supra* note 20, at 669 (citing Duffy, *supra* note 19, the author questions the need for a secrecy element).

For a detailed discussion of the "unique, novel and original" test, see notes 155-171 and accompanying text *infra*.

[51] 39 T.B.A. 732, 743-44 (1937), *aff'd*, 10 F.2d 90 (3d Cir.), *cert. denied*, 310 U.S. 650 (1940). There is interesting language in *Diescher* to the effect that the inventor's rights in his invention were common law rights. *Id.* at 743. The court cited with approval Six Wheel Corp. v. Sterling Motor Truck Co., 50 F.2d 568 (9th Cir. 1931), where the Ninth Circuit stated: "From the foregoing, it will be seen that the irreducible quantum of the inventor's right in the res, even under the common law, is that of making, using and vending . . . . The statutes (referring to the patent laws) certainly do not curtail the natural right; they enlarge it." *Id.* at 571. From the specific facts before the court, i.e., transfer of an unpatented but nevertheless patentable invention, *Diescher* has come to be interpreted so broadly as to support the proposition that industrial knowledge and secret formulas reduced to practice constitute property. *See* United States Mineral Prod. Co., 52 T.C. 177, 196 (1969). One author has cited *Diescher* for the proposition that the products of a man's mind are property whether they are tangible or intangible. *See* Duffy, *supra* note 19, at 1271. *See also* note 47 *supra* for further discussion of the concept of unpatented inventions as property.

[52] 28 T.C. 938 (1957). The court rested its analysis on Edward C. Myers, 6 T.C. 258, 265-66 (1946), an earlier decision where the Tax Court held that an invention becomes a property right when it reaches the "completed conception stage." 28 T.C. at 945. The *Diescher-Speicher* test has also been used in Max A. Burde, 43 T.C. 252, 269 (1964), *aff'd*, 352 F.2d 995 (2d Cir. 1965), *cert. denied*, 383 U.S. 966 (1966); Nelson v. Comm'r, 203 F.2d 1, 6 (6th Cir. 1953); Comm'r v. Stephens-Adamson Mfg. Co., 51 F.2d 681, 682-83 (7th Cir. 1931).

forms of know-how or compilations of information, in and of themselves, will qualify as property under section 351(a). To date, the success of taxpayer-transferor attempts at transfering technical information or know-how has hinged solely upon the relationship between these rights and the other recognized forms of property transferred.[53] Except for a few early cases, the majority of decisions addressing specifically the know-how issue have been post-Revenue Ruling 64-56 decisions. One of the earliest decisions to address the issue of whether know-how constituted a capital asset was the 1947 Tax Court decision *Kimble Glass Co.*[54] In *Kimble* the transferor conveyed the rights to manufacture and sell specific items under a German patent in conjunction with the transferor's agreement to diligently develop his invention, to keep the transferee informed of developments by others in the field, and to submit to the transferee any offers or proposals he might obtain for subsequent licensing of these rights. As might be expected, the court found all of these latter rights to constitute services rather than property.[55] Nine years later the Tax Court, in *Arthur C. Ruge,* cited *Kimble Glass Co.* for the proposition that requiring an inventor to (1) further develop his inventions, (2) transfer future improvements to the transferee, and (3) use his best efforts to promote and develop the particular business involved constituted the performance of services resulting in ordinary income to the transferor.[56] More importantly however, the court found that an agreement to provide a specific number of man days of consulting service per year was "ancillary and subsidiary to" the assignments of the inventions and was "of the type

[53] One reason the courts have examined these assets from the perspective of their interrelationship generally with patents is because the courts have not yet been faced with the issue of transfers of know-how in gross. In fact, to date the courts have continued to struggle with fleshing out the precise meaning of the phrase "know-how." *See* note 43 *supra.* For a detailed discussion of the requisite degree of interrelationship, see notes 56-104 and accompanying text *infra.*

[54] 9 T.C. 183 (1947).

[55] *Id.* at 186. However, petitioner entered into two agreements with a German business. The first agreement provided for the sale of certain patented articles, certain machines for the manufacture of these articles, the furnishing of manufacturing and improvement information, and the training and supplying of a mechanic. *Id.* at 185. In contrast to the items in the second agreement, the court found *none* of these items in the first agreement to constitute the performance of services. *Id.* at 191.

[56] 26 T.C. 138, 143 (1956). The court noted: "In the instant case, we are of the opinion that the services called for by paragraph 6 . . . are similar to those held to be personal services in *Kimble Glass Co.,* . . . and . . . therefore constitute(s) ordinary income."

and kind usually called for to implement the sale of highly technical and intricate inventions," and consequently afforded the "services" property status.[57]

Ruge, therefore, represents the initial formulation of a black-letter-rule for determining when certain assets, expressly recognized as the performance of services, are sufficiently related to other traditionally recognized forms of property transferred to be accorded property status under section 351(a). The greatest contribution of the *Ruge* decision was not its formulation of the "ancillary and subsidiary to" test, but rather its generous and liberal interpretation of the general "property" requirement under section 351. The court in *Ruge* went so far as to grant property status to assets that were inherently nothing more than the performance of services, *i.e.* consulting assistance. A close examination of the *Ruge* test, therefore, reveals that the court was less concerned with formulating a definition of what constitutes property and more concerned with formulating guidelines identifying the requisite relationship or nexus between property and services so as to qualify the entire package for section 351 treatment.[58] Thus, the "ancillary and subsidiary to" test offers little in the way of guidance to the taxpayer seeking to catalogue his assets as qualifying property or nonqualifying services. The true value of the test rests in its offer of property status, regardless of the nature of the assets or services, if the requisite relationship between those services and the recognized forms of property transferred exists.[59]

Taken at face value, the early rulings of the Service con-

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[57] The specific purpose of the consulting services was to assist in the establishment of subsequent control over the manufacturing operations of the actual inventions transferred. *Id.* at 139. Compare these services with those items found not to constitute services in *Kimble Glass Co. See* note 55 *supra.* It is interesting to note that assets clearly classed as services within the agreements themselves were treated as property. *See* note 58 *infra.*

[58] In both *Ruge* and *Kimble Glass Co.*, the dichotomy between "ancillary and subsidiary to," and unrelated, services was quite clear. In both cases, information and even services directly related to the implementation of other recognized forms of property transferred were given property status. *See* notes 55 and 57 *supra. See also* text accompanying note 57 *supra.* In contrast, in these early decisions, services or information only indirectly linked to the tangible property transferred, such as general future improvements, other developments in the field, and future licensing offers, were denied property status. 26 T.C. at 142-43.

[59] The decade following Rev. Rul. 64-56 has witnessed a continuing struggle to identify this requisite relationship. *See* notes 67-72, 101 and accompanying text *infra.*

formed with the initial approach taken by the court in *Ruge*. In Revenue Ruling 64-56, the Service attempted to formulate guidelines as to when know-how constitutes property for purposes of section 351(a).[60] The Service rejected the contention that the mere reduction of know-how to documentary form automatically accorded the information property status.[61] In an attempt to be more specific, the Service noted further that once an item was found to be property, the fact that services were involved in the production of that item did not constitute grounds for denying property status to the entire transfer unless the items transferred had been specifically developed for the transferee.[62] However, recognizing that know-how may inherently consist of both property and services, the Service adopted language identical to the *Ruge* test, ruling that only those services that were "ancillary and subsidiary to" the property transferred would be treated as "property."[63]

The Service soon retreated from its stance taken in Revenue Ruling 64-56. Over the flexible and very liberal language of the former ruling, the Service, in Revenue Procedure 69-19, grafted more onerous requirements for determining whether the transfer

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[60] Rev. Rul. 56, 1964-1 C.B. 133. *See* note 10 *supra*.

[61] *Id.* at 134. To support its position, the Service cited Harold L. Regenstein, 35 T.C. 183 (1960), where the Tax Court found that the information and transfer of a group life insurance concept constituted only the rendering of services, not property. The Service's reliance on this case is questionable, however, for as the *Regenstein* court stated, all that was involved was a release by the transferor of any claim he might have had for compensation for his services in developing the plan. 35 T.C. at 191. It is doubtful that the case may be read as broadly as the Service urged.

[62] Rev. Rul. 56, 1964-1 C.B. at 134. It is interesting that the Service again opted to rest its position upon *Regenstein*, 35 T.C. 183 (1960) rather than H.R. REP. No. 1337, *supra* note 30, at 4254-56. *See also* notes 11 and 12 and accompanying text *supra*. One explanation for such analysis may be found in the breadth of the *Regenstein* holding in contrast to the language found in House Report 1337. In fact, the court in *Regenstein* never addressed the issue of whether the plan or idea could be treated as property because in the court's opinion the petitioners actions constituted only services. 35 T.C. at 190-91.

[63] Rev. Rul. 56, 1964-1 C.B. at 134-35. The Service gave the following examples of what constituted "ancillary and subsidiary to" services: (1) promoting the transaction by demonstrating and explaining the use of the property; (2) assisting in the effective starting-up of the property; (3) performing under a start-up guarantee; or (4) further educating the transferee's employees already possessing a modicum of basic skills. In contrast the Service ruled that the following information failed the "ancillary and subsidiary" test: "(1) training transferee's employees in new skills; (2) continuing technical assistance; and (3) assistance in the construction of plants, machinery housing, or plant layouts." *See* note 17 and accompanying text *supra*. For a more detailed discussion of the ruling, see Cohen, *supra* note 20. *See also* notes 122-179 and accompanying text *infra*.

or know-how would qualify as a section 351(a) property transfer under the prior approval requirements of section 367.[64] First, the Service ruled that transferable information must be secret, unique, novel, and original.[65] In addition, the Service hinted at the severity with which it intended to apply these new rules by declaring that mere knowledge or efficiency gained from experience or skill was not to be considered property, while reiterating its position that the mere reduction of know-how to documentary form was not sufficient to afford such material property status.[66] Thus, by giving qualifying know-how its narrowest construction, the Service necessarily broadened its concept of services and limited the impact of its "ancillary and subsidiary to" exception.

In contrast to the Service's position, the courts' reactions to know-how transfers have generally reflected a desire to broaden the scope of those "services" which will qualify as property at least when the transfer is in some way connected to the transfer of related patents, secret formulas, or secret processes.[67] From *Ruge* through *Howard S. Gable,*[68] a span of almost twenty years, the courts have gone through four subtle, and oftentimes indistinguishable phases. From *Ruge,* in 1956, through Revenue Ruling 64-56, the case law and revenue rulings are analyzed solely in

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[64] Rev. Proc. 19, 1969-2 C.B. 301. On its face Rev. Rul. 64-56 appears to be quite liberal. There is little in the ruling foreshadowing a restrictive prospective application. *See* notes 60-63 and accompanying text *supra.*

[65] *Id.* at 302. *See also* notes 14-16, and accompanying text *supra* and notes 155-171 and accompanying text *infra.*

[66] *Id.* In addition, the Service restated all of the exclusions formulated in Rev. Rul. 64-56, note 63 *supra.* Finally, the Service's two new exclusions in subsections .03(b) and (g) of the Procedure: (1) "The 'information' does not represent mere knowledge, or efficiency resulting from experience, or mere skill in manipulation or total accumulated experience and skill of the transferor . . . and (2) "Technical information of a related or similar nature such as new developments in the field will not be furnished on a continuing basis without adequate compensation . . . ." could be interpreted as inconsistent with Rev. Rul. 64-56. For a critical analysis of the Service's retreat in Rev. Proc. 69-19, see 70-20 TAX MANAGEMENT MEMORANDUM (BNA), 8-11 (Oct. 5, 1970). *See also* notes 172-179 and accompanying text *infra.*

[67] For a general discussion of the court's approaches, see J. BISCHELL, *supra* note 1, at ¶ 6.3a-c; B. BITTKER AND J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 3-13 (3d ed. 1971); Burke, *supra* note 20, at 747-56 (little doubt that intangibles constitute property); Cohen, *supra* note 20, at 38-40 (reference to information developed for the transferee should be construed strictly); O'Connor, *supra* note 19, at 757-58 (cases support a broad definition of property). *See notes* 68-104 and accompanying text *infra* and notes 56-67 *supra.*

[68] 33 T.C.M. (CCH) 1427 (1974).

terms of the "ancillary and subsidary to" test.[69] From 1962 through approximately 1970, in the face of the Service's contraction of the "ancillary and subsidiary to" test, a noticeable judicial shift occurred, not in the flexibility and liberality of the courts' approach to section 351 know-how transfers, but rather in the specific language used by the courts to attain that result. Suddenly an "incident to" test was espoused to enforce the liberal standard inaugurated in *Ruge,* but subsequently misinterpreted by the Service.[70] From 1970 through 1974, the courts experienced a transition period, struggling with the apparent deficiencies of both the "ancillary and subsidiary to" test and the "incident to" test, when confronted with the issue of transfers of know-how only indirectly related to recognized forms of property transferred under section 351.[71] Finally, in 1974, the *Gable* decision marked the rudimentary beginnings of a final phase. Still reflecting the judicial liberality with which know-how transfers had been analyzed since *Ruge, Gable* formulated a new variation on the "ancillary and subsidiary to" test: the "related to" test.[72] The following section of this article will attempt to clarify these nebulous and often overlapping phases by a brief review of the major cases representing each mode of analysis.

Heil Co., a 1962 Tax Court decision was one of the first attempts to determine if a transfer of patents and accompanying know-how could qualify for capital gains treatment.[73] Although decided prior to the release of Revenue Ruling 64-56, *Heil Co.* was decided after the Service announced it was currently reviewing

[69] *Ruge* represents the initial formulation of the "ancillary and subsidiary to" test. There appear to have been no decisions discussing this test until Heil Co., 38 T.C. 989 (1962). By this time, however, the Service had announced it was reviewing the entire area. Prior to the release of Rev. Rul. 64-56 there was nothing to foreshadow an interpretation of the "ancillary and subsidiary to" test by the Service other than that endorsed in *Ruge.*

[70] Beginning with *Heil Co.,* notes 73-78 and accompanying text *infra,* a clear inconsistency arose between the liberal language of Rev. Rul. 64-56 and the Service's actual position. Despite the flexibility hinted at in the ruling, the Service in *Heil Co.,* notes 73-78 *infra, Bell Intercontinental Corp.,* notes 78-79, *infra, United States Mineral Products Co.,* notes 81-86 *infra,* and *PPG Industries, Inc.,* notes 89-91 *infra,* took highly mechanical and conservative anti-know-how positions. The Service's ruling in Rev. Proc. 19, 1969-1 C.B. 301 epitomized this dramatic contrast.

[71] By the 1971 decisions, *Taylor-Winfield Corp.,* and *Francis H. Shepard,* notes 92-94 *infra,* there is little if any mention in the opinions of any requisite degree of relationship between the know-how transferred and the other forms of property transferred.

[72] 33 T.C.M. at 1433. *See* notes 93-99 and accompanying text *infra.*

[73] 38 T.C. 989 (1962).

the know-how transfer guidelines.[74] The specific technical information transferred in *Heil Co.* consisted of assembly drawings, customer lists, notes on manufacturing operations, expert assistance, future developments, and research.[75] Holding that none of this information constituted the performance of services, the Tax Court opined that because the know-how in question was pertinent to the successful use of the patents transferred, it took on the nature of, and was an "incident to", those patents, and therefore was entitled to capital gains treatment.[76] Despite the difference in language, the *Heil Co.* "incident to" test differs little in result or method of analysis from the *Ruge* "ancillary and subsidiary to" test.[77] In fact, the two tests as used in *Heil Co.* seem to be synonomous. The major advantage of the "incident to" test however is its expansion of the *Ruge* test to include past, present, and even *future* services.[78]

Heil Co. was followed in 1967 by *Bell Intercontinental Corp. v. United States.*[79] Again, as in *Heil Co.*, the issue was not a section 351 transfer, but rather whether know-how in conjunction with certain patents qualified as a capital asset under the general

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[74] *See* T.I.R. 308, 1961 IRB 13, 21.

[75] 38 T.C. at 993. In addition, Heil Co. was willing to make its engineers and experts available for consultation with the transferees employees. *Id.* at 993-94. All of this information related to the development of certain heavy construction machinery.

[76] *Id.* at 1003. The court noted that, after reviewing the contract, it was unable to discover any provisions which provided for the rendering of services by petitioner to the transferee. *Id.* at 1002. With respect to future information, the court simply refused to interfere with the parties' own evaluation of the nature and worth of the rights transferred. *Id.* at 1003.

[77] *Compare* text accompanyng note 57 *with* note 75 and accompanying text *supra.*

[78] The past services consisted of Heil's own efforts to develop the information; the present services consisted of consultation with Heil's engineers and experts; and finally, the future services consisted of any future developments or improvements. *Id.* at 993-998.

Heil Co. has served as the cornerstone in the development of the concept of know-how transfers and the issue of whether they constitute property. The Service has issued guidelines as to what will not be considered "ancillary and subsidiary to" services. *See* notes 60-63 and accompanying text *supra.* In effect *Heil* foreshadowed a recognition as property of many of the forms of information subsequently denied property status under the Service's rulings and procedures. Using the phrase "incident to" rather than "ancillary and subsidiary to," the court found that engineering and manufacturing assistance, design improvements, notes on manufacturing operations, and commercial and manufacturing data were capital assets regardless of their temporal relation, past, present or future, to the actual transfer. Therefore, the greatest benefit of the "incident to" test was its broadening of the temporal relationship between the actual transfer and earlier or subsequent service-oriented developments. For further analysis of the "incident to" test, see notes 79-91 and accompanying text *infra.*

[79] 381 F.2d 1004 (Ct. Cl. 1967).

capital gains sections 1221 and 1222. As in *Heil Co.*, the information involved consisted of manufacturing and engineering data, and the Court of Claims, finding such know-how to constitute a capital asset, again relied upon the "incident to" test rather than the "ancillary and subsidiary to" test of Revenue Ruling 64-56.[80] *Bell,* like *Heil Co.*, represents a sharply different attitude toward the scope of section 351 from that urged by the Service.

In 1969, in *United States Mineral Products Co.*, the Tax Court reviewed the applicability of the capital gains provisions, specifically section 1221, to the transfer of manuals, reports, quality control procedures, tests, data, and other documents to a wholly-owned Canadian subsidiary.[81] Attempting to reconcile the widening gap emerging between the interpretation by the *Heil Co.* and *Bell* decisions of the "incident to" test and the Service's dogged adherence to a very restrictive view of the "ancillary and subsidiary to" test, the Tax Court noted that because the know-how in question was unique to and necessary for effective utilization of the patents transferred, it was an "incident of" the patents.[82] Continuing, the court stated: "Assuming *arguendo* that this information was equivalent to consulting services . . . we find that it was of the type usually called for to implement the sale of highly technical inventions and, thus, was ancillary and subsidiary to the assignments of the formulas."[83] It is interesting to note that the court's use of the "ancillary and subsidiary to"

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[80] Bell executed agreements with Agusta concerning the transfer of certain patents and production know-how including manufacturing and engineering data for production of a helicopter. Curiously, in light of the court's reliance upon the "incident to" test, the court found that the know-how transferred was not dependent upon the patent drawings. *Id.* 1019-20. Unfortunately, the court did not identify the specific items constituting the know-how. Additionally, it is important to note that the court relied exclusively on the *Heil Co.* "incident to" test with only an oblique reference to Rev. Rul. 64-56. *Id.* at 1020. Clearly, the "incident to" test was seen as a more flexible alternative to the restrictive interpretation by the Service of Rev. Rul. 64-56's guidelines.

[81] 52 T.C. 177 (1969). Specifically, petitioner transferred formulas, processes, patents, manuals containing technical information, consultation with the transferee's employees as to the use of all information transferred, disclosure of all future inventions and improvements during the term of the agreement, and an agreement to conduct, publish, and publicize future test results on the products. *Id.* at 179-80.

[82] "Without these products a proper application of the . . . products would have been difficult or impossible. This information was an incident of the patents and assumed their nature as capital assets." *Id.* at 199. Again as in *Bell,* note 80 *supra,* the court refused to apply the Service's version of the "ancillary and subsidiary to" test.

[83] *Id.*

test was more conclusory than analytical. Only after analyzing the know-how in terms of the "incident to" test did the court feel any obligation to express its result in language acceptable to the Service.[84] Nevertheless, this broadening of the "ancillary and subsidiary to" test by reliance upon the "incident" test was clearly contrary to the position urged by the Service.[85] Also noteworthy was the fact that the court cited *Ruge* and Revenue Ruling 55-17, rather than Revenue Ruling 64-56, in support of its broad interpretation of the "ancillary and subsidiary to" test.[86]

Subsequent to the decision in *Mineral Products Co.*, the Service released Revenue Procedure 69-19.[87] Although the Procedure made no mention of *Mineral Products* or its predecessors, it did break new ground for section 351 transfers of know-how by providing that: (1) The information must be secret in the strictest sense of the word; (2) it must represent a discovery that is origi-

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[84] 52 T.C. at 199.

[85] *See* notes 80 and 82 *supra*. The information transferred probably ran afoul of Rev. Rul. 56, 1964-1 C.B. 133, because not all of it was secret, it constituted technical assistance after the start-up phase, and was merely educational in nature. *See* the discussion of Rev. Rul. 64-56 and Rev. Proc. 69-19 in notes 60-63 and 64-66 *supra*, and notes 122-179 and accompanying text *infra*.

[86] Interestingly, the cited support for the "ancillary and subsidiary to" test was Arthur C. Ruge, 26 T.C. 138 (1956) and Rev. Rul. 17, 1955-1 C.B. 388, not Rev. Rul. 56, 1964-1 C.B. 133. Without any reference to "ancillary and subsidiary to" services, Rev. Rul. 55-17 simply ruled:

> The right to use such 'know-how' is not materially different from the right to use . . . secret processes and formulae, and, if the right thereto is granted as part of a licensing agreement, it becomes, in effect, an integral part of the bundle of rights acquired. . . .
>
> The payments made . . . are applicable both to . . . the 'know-how', and to services performed . . . in instructing and training the employees . . . . Since the personal services have only nominal value apart from the license to use such 'know-how,' all but a nominal sum should be allocated to the license.

Id. at 389.

Ruge is more directly on point and its initial interpretation and formulation of the "ancillary and subsidiary to" test is more nearly approximated by the "incident of" test of *Heil Co.* and *Mineral Products*. The *Ruge* court stated: "The consulting services . . . were ancillary and subsidiary . . . to the inventions . . . and are of the type and kind usually called for to implement the sale of highly technical and intricate inventions." 26 T.C. at 143. One may speculate that the *Mineral Products* court's reliance on the "incident to" language represented an attempt to maintain the breadth of the "ancillary and subsidiary to" test as originally formulated in *Ruge* but subsequently erroneously reinterpreted by the Service in Rev. Rul. 64-56. *Compare* text accompanying note 83 *supra* *with Ruge*, 26 T.C. at 143.

[87] Rev. Proc. 19, 1969-2 C.B. 301.

nal, unique, and novel; and (3) following from the two requirements above, the information may not represent mere knowledge or efficiency gained from experience or skill.[88] Immediately following the release of Revenue Procedure 69-19 the Tax Court was again faced with the issue of the proper treatment of the transfer of patents and accompanying know-how, in *PPG Industries, Inc.*[89] Referring both to the Service's "ancillary and subsidiary to" test and the "incident to" test, the court recognized that even after-acquired information may come within the *Heil* and *Mineral Products Co.* "incident to" test for property[90] under section 1211 of the Code. As in *Heil Co.*, the court's use of the "ancillary and subsidiary to" test in conjunction with the "incident to" test reflected both an implicit rejection of the Service's highly mechanical and restrictive interpretation of the *Ruge* test, in Revenue Ruling 64-56, and a continued adherence to the more liberal approach developed in prior decisions.[91]

A major step forward came in the 1971 decision *Taylor-Winfield Corp.* where, without citation of any past case law, the court simply asserted that it was "settled" that the transfer of unpatented technology, such as know-how, could be the subject of a sale, and that technical data should be treated, for section

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[88] *Id.* at 302. *See* the brief discussion of the Procedure in note 66 *supra*. For a detailed discussion of Rev. Proc. 69-19 see generally Burke, *supra* note 20, at 755; Flyer and Buell, *supra* note 4, at 27-28; TAX MANAGEMENT MEMORANDUM, *supra* note 66. Though the Procedure does not expressly so state, many of its new prohibitions strike directly at the developments in *Heil Co.*, *Bell Intercontinental Corp.*, and *Mineral Products*. *See* notes 73-85 and accompanying text *supra*. *See also* notes 122-179 and accompanying text *infra*.

[89] 55 T.C. 928 (1970). The assets transferred to the corporation consisted of patents, trade secrets, research and development data, technical information and know-how, including engineering, scientific and practical information and formulae, manufacturing data and procedures, machinery, plant and equipment designs, information or materials and commercial sources thereof, technical information in reports and drawings, blueprints, and specifications, along with all such future information coming into the possession of the transferor during the term of the agreement. *Id.* at 975, 977, 979-80, 983.

[90] The court cited with approval the applicability of the *Heil Co.* "incident to" test even for information conveyed after the date of the agreement. *Id.* at 1015-16. Referring to *Heil Co.* and *Mineral Products*, the court referred to the "ancillary and subsidiary to" test but clearly applied something more akin to the earlier discussed "incident to" test. Interestingly, the court found that the materials in question implemented the patented and unpatented information transferred, and made possible the effective utilization of such technology. The court reasoned therefore that the materials were "ancillary and subsidiary." *Id.* at 1018. In *PPG*, the court used the more liberal test to find that certain know-how constituted property but relied upon the more restrictive test to phrase its conclusions.

[91] *See* notes 73-78 and 80 and accompanying text *supra*.

1235 capital gains purposes, in a manner similar to patents.[92] Again, the nature of the know-how transferred was similar to that transferred in the earlier discussed decisions and probably came within the prohibitions of Revenue Procedure 69-19.[93] Interestingly, no mention was made of the procedure. Tempering the broad language employed by the court, however, was the fact that in conjunction with the transfer of know-how, Taylor-Winfield did transfer certain patents and processes. Addressing the "transfer" issue, the court emphasized that the value of these patents was not insignificant.[94]

The most recent Tax Court examination of the know-how issue occurred in 1974, in *Howard S. Gable*. Citing all of the earlier discussed opinions, the court, in an ambiguously worded opinion, advanced a new "related to" test and interpreted it very liberally.[96] Addressing an issue often avoided in the past, the court noted that underlying any patent transfer is a transfer of knowledge, knowledge a transferee is likely to require to imple-

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[92] 57 T.C. 205, 213 (1971). The specific information transferred consisted of engineering data, designs, research, developments, drawings, layouts, reports and any future developments and patents. *Id.* at 207.

It is interesting to note that by disregarding the patents transferred, and looking at the know-how in isolation, *Taylor-Winfield* recognized that technical data is to be treated similarly to patents. *Id.* Conspicuously missing in the opinion is any reference to a requisite relationship between patented and unpatented materials transferred. *Id.* at 217.

[93] *Compare* notes 57, 75, 80, 81 and 89 and accompanying text *with* notes 63-66 and accompanying text *supra*.

[94] 57 T.C. at 217.

Taylor-Winfield was followed by *Francis H. Shepard*, 57 T.C. 600 (1972), *rev'd* 481 F.2d 1399 (3d Cir. 1973) (Unpublished Opinion), *cert. denied*, 417 U.S. 911 (1974). In *Shepard* the lower court examined the transfer in question and found that the payments made were only in consideration for certain technical information including drawings, designs, and blueprints. The lower court accorded this technical information capital asset treatment. *Id.* at 609-615. It is difficut to ascertain whether the decision was reversed on this ground. In contrast to all the cases prior to *Shepard*, including *Taylor-Winfield, Shepard* was the first to favorably address technical information in gross, although the court was careful to note that all of the information transferred related to a patented invention covered in the original agreement but never actually transferred to the transferee. *Id.* at 612-615. The precedential value of *Shepard* however is highly questionable in light of its unexplained reversal.

[95] 33 T.C.M. (CCH) 1427 (1974).

[96] *Id.* at 1433. The court formulated a test even more flexible and liberal than the "incident to" test. The court held: "The rule is to be applied to exempt from treatment as services not only the communication of existing know-how, but the development of further information *as long as it relates to the property* transferred and constitutes assistance rendered in connection with the transfer." (Emphasis added.) *Id.*

ment and develop the property transferred.[97] Recognizing the necessity of this know-how to the value of the property transferred, and distinguishing services specifically related to an invention from services meant only to advance the transferee's business in a general sense, the court afforded property status to that information "related to" the property transferred.[98] In summary, *Gable* must be viewed with caution because of the extremely imprecise language employed by the court. Nevertheless, the "related to" test perhaps marks the beginning of a broader approach to know-how transfers that may be sufficiently flexible to encompass even transfers of know-how in gross.[99]

In retrospect, the post-1964 know-how decisions reveal a judicial willingness to stretch the language of Revenue Ruling 64-56 to its broadest and most liberal limits, and to ignore the more conservative gloss put on the ruling by the Service in Revenue Procedure 69-19.[100] The decisions have evidenced an increasing liberality toward section 351 transfers of know-how. From *Heil Co.*, in which the touchstone test focused on the degree of dependence of the know-how transferred upon the other property in the transaction, the Tax Court has progressed and broadened its analysis by means of the "related to" test. In effect, *Gable* may foreshadow an analytical framework focusing not predominantly on the property aspects of the transferred patents alone, but rather on the independent property status of each of the rights transferred, both patents and know-how.[101]

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[97] *Id.*

[98] The specific information transferred by Gable consisted of inventions, compounds, processes, improvements thereon, technical information, patents, and an agreement to continue further work, development, and experiments. *Id.* at 1429. The court termed the "essence of the transaction" the sale of a patent, and the performance of any services only a step in developing the property transferred. *Id.* at 1432.

[99] *See* note 101 and accompanying text *infra.*

[100] To date, the courts have simply ignored Rev. Proc. 19, 1969-2 C.B. 301.

[101] In *Heil,* discussion in notes 73-78 and accompanying text *supra,* the very nature of the "incident to" test required a two-step analysis. First the court examined the transaction to determine if property has been transferred. Only after answering the first question in the affirmative did the court address the second issue, that is, whether any non-property assets (i.e., know-how) in and of themselves, are incidental to the successful utilization of the property transferred. This pattern repeats itself in *Bell, Mineral Products,* and *PPG Industries,* discussed at notes 78-79, 81-86 and 89-91 and accompanying text *supra.*

A subtle shift in language and focus occurred in *Taylor-Winfield,* 57 T.C. 205 (1971) and the lower court decision in *Francis H. Shepard,* 57 T.C. 600 (1972) *rev'd,* 481 F.2d

Certainly this method of analysis is at odds with the restrictive reformation of the Service's position found in the most recent revenue rulings and procedures.[102] Perhaps the best example of the ever-widening divergence of the Tax Court decisions and the Service's published position may be seen in the area of transfers of future services. In *Gable*, the court noted that earlier decisions had recognized that the development of further information for the transferee by the transferor, as long as it "related to" the earlier transferred property, was still exempt from treatment as services under section 351.[103] Although an accurate statement of prior case law, this statement is totally contrary to the Service's position as expressed in both Revenue Ruling 64-56 and Revenue Procedure 69-19: Technical information of a related or similar nature such as new developments in the field may not be furnished on a continuing basis to the transferee without adequate compensation (in other words, ordinary income treatment).[104] Admitting this is only one of many examples of the conflict between the Service's guidelines and the case law devel-

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1399 (3d Cir. 1973) (Unpublished Opinion), *cert. denied*, 417 U.S. 911 (1974) (stating that unpatented technology by itself could be the subject of a sale and that "technical data" should be treated for tax purposes similarly to patents.) Interestingly, the information involved in *Taylor-Winfield* was not an incident of a patent, but only related to unpatented items. *See* note 92 *supra*. In *Shepard*, a patent, involved in the license agreement, was never transferred. *See* note 94 *supra*.

By 1974, the court had come full circle. In *Gable*, 33 T.C.M. (CCH) 1427 (1974), by recognizing that in any transfer of technical information and know-how, knowledge constitutes a large part of the transfer, the court implicitly shifted its perspective to recognize that know-how itself is deserving of property status coequal with that of patents. A transfer of technical information is more than simply a separate transfer of patents and dependent know-how in the same agreement; the transfer is one of interrelated and interdependent coequal property components; in effect, the transfer is a package of property assets. Consequently, the "related to" test removes the stigma of dependence or market inferiority attached to know-how by the "incident to" or "ancillary and subsidiary to" tests, and in its place recognizes the distinct and separate property aspect of know-how in and of itself. To support this analysis, *see* Flyer and Buell, *supra* note 19, at 26, 29.

[102] *See* notes 24, 60-66 *supra*.

[103] 33 T.C.M. (CCH) at 1433. In *Heil Co.*, 38 T.C. at 993-94, the Tax Court included as property the furnishing of future consultation services relating to the inventions transferred. *See* notes 75-78 *supra*. Similar treatment was given an agreement for future consultation, and future developments and improvements in *Mineral Products*, 52 T.C. at 199. *See* notes 81-86 *supra*. *See also Shepard*, 57 T.C. at 605, *rev'd*, 481 F.2d 1399 (3d Cir. 1973) (Unpublished Opinion), *cert. denied*, 417 U.S. 911 (1974) (future inventions and improvements); *Taylor-Winfield*, 57 T.C. at 209 (future developments and improvements); *PPG, Inc.*, 55 T.C. at 1015 (future services and the *Heil Co.* decision).

[104] Rev. Proc. 19, 1969-2 C.B. 301. *See also* notes 64-66 and accompanying text *supra*, and notes 172-179 and accompanying text *infra*.

opments, it is perhaps the most dramatic example of the near total rejection by the courts of the Service's unfounded and arbitrary distinction between services and property for purposes of section 351.

II. Know-How in Gross: Property as Defined by Federal Law

The tax decisions discussed in the preceding section indicate that anything which by law constitutes property, should also represent property for purposes of section 351. In *E.I. DuPont de Nemours & Co. v. United States,* the Court of Claims defined property as "that commonly thought of in the business world as a positive business asset."[105] *DuPont* was followed four years later by *Stafford v. United States* in which the Middle District Court of Georgia broadened the *DuPont* property definition to include any real or personal, tangible or intangible property, or any asset which the owner has a right to possess, own or dispose of.[106] Admittedly, property may not, and probably should not, be defined so broadly as to include anything which may represent a benefit to the parties, a definition foreshadowed by the broad dicta in *Stafford.*[107] However, at a minimum, property for purposes of section 351 should encompass everything which is generally recognized as a legally protected interest; the specific holdings in *DuPont* and *Stafford* mandate no less.

The "legally protected interest" construction of the term "property" provides the taxpayer with an arsenal of weapons with which to attack the only restrictive pronouncements of the Service. The vast majority of states define legally protected information in terms of the Restatement of Torts, section 757, defining "trade secret": A trade secret may consist of any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it.[108] As will be noted below, recent nontax federal cases have also endorsed this definition of legally protected information. Since the broad concepts of "property" expressed in *DuPont* and *Stafford* must at

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[105] 471 F.2d at 1218. *See* the discussion in notes 34-37 and accompanying text *supra.*

[106] 435 F. Supp. at 1038. *See* the discussion in note 39 and accompanying text *supra.*

[107] 435 F. Supp. at 1038-39.

[108] Restatement of Torts § 757, comment b (1939) *See generally* Klein, *The Technical Trade Secret Quadrangle: A Survey* 55 Nw. U.L. Rev. 437 (1960).

least encompass legally protected interests and since federal courts define legally protected information in terms of the widely employed Restatement of Torts definition of "trade secret," must not this definition also be binding on the Service for the purpose of determining qualifying know-how transfers under section 351? In this fashion, the Restatement can be employed to provide clear guidelines to the taxpayer as to what forms of know-how will and should be granted property status. The analysis which follows attempts to outline the specific instances where, contrary to the Service's pronouncements, know-how transfers should qualify as property for the purpose of section 351.

At one time serious questions existed as to whether any non-patented intellectual property could be protected by the states. Arguments were made that *Lear, Inc. v. Adkins*[109] stood as a precedent for the rule that federal patent law preempted state trade secret law.[110] This controversy was put to rest by the Supreme Court in *Kewanee Oil Co. v. Bicron Corp.*[111]

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109 Lear, Inc. v. Adkins, 395 U.S. 653 (1969).

110 In *Lear* the Court expressly refused to rule on the issue of whether royalties legally could be collected for the license of a trade secret. The Court, however, intimated that its ruling with respect to licensee estoppel might cast a broader shadow on trade secret law: "Our decision today will, of course, require the state courts to reconsider the theoretical basis of their decisions enforcing the contractual rights of inventors and it is impossible to predict the extent to which this re-evaluation may revolutionize the law of any particular State in this regard." *Id.* at 675.

Viewed in terms of such earlier decisions as Sears, Roebuck & Co. v. Stiffel Co., 376 U.S. 225 (1964) and Compco Corp. v. Day-Brite Lighting, Inc., 376 U.S. 234 (1964), many commentators expressed doubt as to whether state protection of trade secrets could survive a challenge based upon preemption by the federal patent laws. Kewanee Oil Co. v. Bicron Corp., 478 F.2d 1074 (6th Cir. 1973), *rev'd*, 416 U.S. 470 (1974); Painton & Co. v. Bourns, Inc., 309 F. Supp. 271 (S.D.N.Y. 1970), *rev'd*, 442 F.2d 216 (2d Cir. 1971); Adelman & Jaress, *Inventions and the Law of Trade Secrets After* Lear v. Adkins, 16 WAYNE L. REV. 77 (1969); Arnold and Goldstein, *Life Under* Lear, 48 TEXAS L. REV. 1235 (1970); Milgrim, *Sears to Lear to Painton: of Whales and Other Matters*, 46 N.Y.U. L. REV. 17 (1971); Note, *Federal Preemption of State Trade Secret Law: Existing Theories and a Proposed Solution*, 24 CASE W. RES. L. REV. 799 (1973); Note, *The Viability of Trade Secret Protection After* Lear v. Adkins, 16 VILL. L. REV. 551 (1971). Doerfer, *The Limits on Trade Secret Law Imposed by Federal Patent and Antitrust Supremacy*, 80 HARV. L. REV. 1432 (1967). *See* Hawkland, *Some Recent American Developments in the Protection of Know-How*, 20 BUFF. L. REV. 119 (1970). *See also* Doerfer, *The Limits on Trade Secret Law Imposed by Federal Patent and Antitrust Supremacy*, 80 HARV. L. REV. 1432 (1967); Note, *The Scott Amendment to the Patent Revision Act: Should Trade Secrets Receive Federal Protection*, 1971 WIS. L. REV. 900.

111 416 U.S. 470 (1974).

The *Kewanee* Court made two important determinations: (1) that states had the power to protect intellectual property,[112] and (2) that specific state protections, at least when in conformity with the Restatement of Torts definition of trade secret, did not conflict with the federal patent laws.[113] The Court reasoned that federal patent protection and the Restatement's protection of trade secrets were complementary, serving the same purpose of promoting business invention and efficiency.[114] As a result, state protection of trade secrets, as enunciated by the Restatement, is not only permissible but desirable.[115] In other words, compilations of information meeting the standards of the Restatement can and should represent a legally protected interest. Viewed in terms of the *Hempt Bros.* and *Stafford* cases, which state that any rights

[112] 416 U.S. at 478-79. *See* Sears v. Gottschalk, 502 F.2d 122, 132 (4th Cir. 1974), *cert. denied*, 422 U.S. 1056 (1975); Richter v. Westab, Inc., 529 F.2d 896, 901 (6th Cir. 1976); Analogic Corp. v. Data Translation, Inc., 358 N.E.2d 804 (Mass. 1976).

[113] 416 U.S. at 491. *See* Painton & Co. v. Bourns, Inc., 442 F.2d 216 (2d Cir. 1971). See the following commentaries for discussions of the *Kewanee* holdings: Stern, *A Reexamination of Preemption of State Trade Secret Law after* Kewanee, 42 GEO. WASH. L. REV. 927 (1974); Note, *Survival of State Protection for Trade Secrets*, 28 ARK. L. REV. 491 (1975); Note, *Trade Secrets: Federal Patent Law Does Not Preempt State Laws Protecting Trade Secrets Which, Although Appropriate Subjects for Patent Protection, Are Ineligible for Patent Protection Because They Have Been in Public Use for More Than One Year*, 41 BROOK. L. REV. 682 (1975); Note, *State Trade Secret Protection is not Preempted by Operation of United States Patent Law*, 12 HOUS. L. REV. 191 (1974); Note, *Constitutional Law—Patents and Trade Secrets—Federal Patent Law Does Not Preempt State Trade Secret Law*, 51 N.D. L. REV. 212 (1974); Note, *Trade Secrets - Federal Patent Code Does Not Preempt State Trade Secret Statutes*, 28 RUT. L. REV. 191 (1974); Note, *Constitutional Law - Patent Clause - Status May Afford Trade Secret Protection Without Infringing Upon Federal Patent Power*, 20 VILL. L. REV. 225 (1974); Note, *Accommodation of Federal Patent and the State Interest in Trade Secrets*, 16 WM. & MARY L. REV. 171 (1974); Note, *Patent Law - No Federal Preemption of State Trade Secret Law*, 1974 WIS. L. REV. 1195.

[114] "Trade secret law will encourage invention in areas where patent law does not reach, and will prompt the independent inventor to proceed with the discovery and exploitation of his invention. Competition is fostered and the public is not deprived of the use of valuable, if not quite patentable, inventions." 416 U.S. at 485

[115] The Court discusses the need for state trade secret protection as follows:

> Trade secret law encourages the development and exploitation of those items of lesser or different invention than might be accorded protection under the patent laws, but which items still have an important part to play in the technological and scientific advancement of the Nation. Trade secret law promotes the sharing of knowledge, and the efficient operation of industry . . . . Congress, by its silence over these many years, has seen the wisdom of allowing the States to enforce trade secret protection.

416 U.S. at 493.

which can be possessed, used, or transferred represent property, *Kewanee's* endorsement of trade secret protection in general, and the Restatement in particular, should serve to establish minimum guidelines with respect to what forms of secret information transfers will be granted nonrecognition status under section 351(a).

Indeed, subsequent decisions have cited *Kewanee* for the rule that the Restatement represents the federal definition of a protected trade secret. Faced with the task of construing "trade secret" for the purpose of the Freedom of Information Act, the Ninth Circuit relied on *Kewanee's* reference to the Restatement: "The Supreme Court has defined 'trade secret' as it applies to the patent laws as a 'compilation of information' which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it."[116] In another case addressing the scope of the Freedom of Information Act, the District Court for the District of Columbia, quoting from *Kewanee,* stated that the court "must make a threshold determination whether such materials fall within the 'widely relied-upon definition of trade secret found at 4 *Restatement of Torts* § 757, comment b (1939).' "[117] Similarly, in those instances where the court has not specifically addressed local law,[118] or where local law is in doubt,[119] the Restatement inevitably emerges as the standard the court applies in defining what constitutes a protected trade secret. These post-*Kewanee* decisions, by specifically adopting the Restatement's definition of protected information for the pur-

[116] Union Oil Co. of Calif. v. FPC, 542 F.2d 1036, 1044 (9th Cir. 1976). *See* Rel-Reeves, Inc. v. United States, 534 F.2d 274, 297 (Ct. Cl. 1976) (citing both the Restatement of Torts and *Kewanee* for what is protectable as a trade secret property right under an armed service procurement regulation defining "proprietary data"); Truck Equipment Service Co. v. Fruehauf Corp., 536 F.2d 1210, 1215 (8th Cir. 1976), *cert. denied,* (In a case involving unfair competition under the Lanham Act, the court cited *Kewanee* for the proposition that those who invest time and money in the development of goodwill should reap the benefits of their energy); Pharmaceutical Man. Ass'n v. Weinburger, 411 F. Supp. 576, 580 (D.D.C. 1976) (assessing the propriety of a FDA regulation by comparing it to the Restatement of Torts definition of trade secret).

[117] Ashland Oil Inc. v. FTC, 409 F. Supp. 297, 303 (D.D.C.), *aff'd* 548 F.2d 977 (D.C. Cir. 1976).

[118] Timely Prods. Corp. v. Arron, 523 F.2d 288, 303 (2d Cir. 1975); Telex Corp. v. I.B.M. Corp., 510 F.2d 894 (10th Cir.), *cert. dismissed,* 423 U.S. 802 (1975); Kodeky Elecs., Inc. v. Mechanex Corp., 486 F. 2d 449 (10th Cir. 1973).

[119] Tri-Tron Int'l v. Velto, 525 F.2d 432, 436 (9th Cir. 1975); Keystone Plastics, Inc. v. C&P Plastics, Inc., 506 F.2d 960, 964 (5th Cir. 1975); K-2 Ski Co. v. Head Ski Co., Inc., 506 F.2d 471, 473 (9th Cir. 1974).

poses of federal law, reinforce the conclusion that *Kewanee* requires that the Service recognize the Restatement standards of what information represents property. *Kewanee's* endorsement of the Restatement, when construed together with the broad definition of property in *DuPont* and *Stafford* must therefore bind the Service to the Restatement's definition of protected information for purposes of section 351. As demonstrated in Part II, there has been little controversy over whether secret formulas or secret patterns and devices (*i.e.* secret processes) are recognized as property. Similarly, cases interpreting section 351 seem to hold that virtually any valuable compilation of information will also qualify as property when the information transfer is an "incident of" the transfer of patents, secret formulas, or secret processes. The unanswered question is what forms of know-how, *independent of any patents or trade secrets,* will qualify as property. By applying the Restatement to section 351 this question is answered as well.

To illustrate the impact of the Restatement, the analysis which follows highlights those specific positions taken by the Service which cannot withstand judicial attack when judged against the Restatement. Specifically, the authors will address two fundamental tests which the Service apparently requires that the taxpayer meet before a know-how transfer will be granted nonrecognition status under sections 351 and 367: (1) The information must be absolutely secret, that is, known only to the owner and employees who use it; and (2) in addition to being a discovery, the information must be original, unique and novel. Admittedly these tests apply only to the limited issue of whether a transfer will be granted prior approval under the now obsolete advance notice rules of section 367.[120] In light of the Tax Reform Act's recent adoption of a post-transfer review procedure, the standards expressed in Revenue Procedure 69-19 may no longer necessarily reflect the Service's position with respect to what forms of know-how will qualify under section 351. However, since the requirements articulated in the Revenue Procedure appear to be designed to supplement the ambiguous rules expressed in Revenue Ruling 64-56, the Revenue Procedure must substantially reflect the Service's position with respect to section 351 as well.

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[120] *See* note 3 *supra* for the changes in section 367 implemented by the Tax Reform Act of 1976.

Indeed a careful reading of the Procedure commands this conclusion.[121]

The authors will demonstrate how neither the "absolute secret" nor the "unique and novel" tests can stand as appropriate guidelines for what should constitute property under section 351(a) when compared against the Restatement. Having reached this conclusion, the authors will further highlight how other more specific positions taken by the Service with respect to know-how also must give way in the face of contrary legal authority.

A. *Must the Information Be Absolutely Secret?*

Although Revenue Ruling 64-56 requires information to be secret before it will be granted property status,[122] it was not until Revenue Procedure 69-19 was issued that the Service stated what it meant by "secret." First, "adequate safeguards" must have been taken "to guard the secret against unauthorized disclosure."[123] This demand for adequate safeguards presumably does not differ materially from the common law requirement that the owner take "reasonable" precautions under the circumstances to protect his secret.[124] However, the Service's second requirement

[121] The Revenue Procedure demands that the taxpayer represent that the information is property under section 351 as defined by Revenue Ruling 64-56, and that the information is protected under U. S. law, the law of the transferor. The Procedure then states: "In making such representations the taxpayer should . . . state" that the information is absolutely secret and that it is original, unique, and novel. 1969-2 C.B. at 302. Since "such representations" must refer to the property and protection requirements, one must necessarily assume that the dual tests which follow represent the Service's interpretation of governing U.S. law.

[122] In Revenue Ruling 64-56 the Service stated that property consists of secret processes, secret formulas, and secret information "in the general nature of a patentable invention . . . . Other information which is secret will be given consideration as 'property' on a case-by-case basis." 1964-1 (Part 1) C.B. at 134.

[123] 1969-2 C.B. at 302.

[124] R. MILGRIM, *supra* note 7, § 2.04 at 2-26 to 2-27 (1977); *See, e.g.*, K-2 Ski Co. v. Head Ski Co., 506 F.2d 471, 474 (9th Cir. 1974); Structural Dynamics Research Corp. v. Engineering Mechanics Research Corp., 401 F. Supp. 1102, 1110 (E.D. Mich. 1975); Allen Mfg. Co. v. Loika, 145 Conn. 509, 144 A.2d 306, 310 (1958); Space Aero Prods. Co., Inc., v. R. E. Darling Co., 238 Md. 93, 208 A.2d 74, *cert. denied*, 382 U.S. 843 (1965); Sun Dial Corp. v. Rideout, 16 N.J. 252, 108 A.2d 442 (1954); General Analine & Film Corp. v. Frantz, 50 Misc.2d 994, 272 N.Y.S.2d 600, 606, *judgment modified*, 52 Misc.2d 197, 274 N.Y.S.2d 634 (Sup. Ct. 1966).

The Restatement of Torts mentions "the extent of measures taken by him to guard the secrecy of the information" and "the extent to which it is known by employees and others involved in his business" as two of the six factors to consider in evaluating whether a trade secret exists. RESTATEMENT OF TORTS § 757 at 6. Significantly the Supreme Court that the information be "known only by the owner and those confidential employees who require the 'information' for use in the conduct of the activities to which it is related. . . ."[125] deviates substantially from the standards expressed in the Restatement. This "absolute" view[126] of secrecy can derive only from the Service's fundamental misinterpretation of the proprietary interests embodied in a trade secret, in general, and know-how, in particular.

The Service has attempted to impose upon trade secrets and know-how tests appropriate only for patents.[127] Patent rights and trade secret rights are fundamentally different concepts requiring fundamentally different rules of analysis. A patent is a grant of an absolute monopoly. The invention is a secret until a patent application is approved, whereupon the invention is publicly disclosed. In exchange for disclosure, the Government grants the inventor a monopoly in the invention, limited to a seventeen-year term.[128] The patentee's monopoly includes the right to prevent independent creation and use of the invention.[129]

A trade secret is information of sufficient competitive value so that one who does not know the information cannot appropriate the information to himself or another in breach of a confidence. It involves an obligation of fair dealing, implied from the very value of the information itself or created by express contract.[130] Unlike a patent, the owner has no right to prevent one who independently discovers such information from using it; the

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in *Kewanee* stated that one of the disadvantages that would result from denying trade secret protection would be *excessive* security measures. 416 U.S. at 486.

[125] 1969-2 C.B. at 302.

[126] Those few authorities stating the "absolute" view that a secret can be known only by the owner and employees with a need to know generally do so gratuitously. In other words, it is rare, if ever, that a court will employ the absolute secrecy doctrine as a rule of decision in a case. See R. MILGRIM § 2.07[2] at 2-75 to 2-76 & n. 11.

[127] *See also* the discussion of the Service's novelty requirement at text accompanying notes 155-159 *infra.*

[128] 416 U.S. at 481. Contrast rights in a trade secret which survive as long as the information remains secret. American Dirigold Corp. v. Dirigold Metals Corp., 125 F.2d 446 (6th Cir. 1942).

[129] Kewanee Oil Co. v. Bicron Corp. 416 U.S. 470, 478 (1974).

[130] In essence a trade secret action is one for "inequitable competition arising from a breach of trust." Vulcan Detinning Co. v. American Can Co., 72 N.J. Eq. 387, 67 A. 339, 343 (1907) (granting trade secret protection despite the fact that the secret had been stolen before). *See also* Nash, *The Concept of 'Property' in Know-how as a Growing Area of Industrial Property: Its Sale and Licensing,* 6 PAT. T.M. & COPYRIGHT J. OF RESEARCH & EDUC. 289 (1962).

owner's rights therefore are not exclusive.[131] The owner does, however, have the right to prevent another from appropriating information discovered and developed by the owner's efforts. Having expended time and money to make a discovery, the owner has the right to force competitors to make the same investment of their own time and money.[132] The owner retains his right until that point in time when the information becomes generally known.[133]

Since a trade secret action is essentially an action for misappropriation, a requirement of absolute secrecy is irrelevant in defining the trade secret right. The protective rights derive from the competitive value of the information. It does not matter if only the owner and a minimum number of employees know the secret. Rather what matters is whether knowledge of the secret is sufficiently limited so that one who does not know the information cannot equitably appropriate it from one who does know it.[134]

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[131] "A trade secret law, however, does not offer protection against discovery by free and honest means, such as by independent invention, accidental disclosure, or by so-called reverse engineering. . . ." Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 476 (1974). Rather the holder of a trade secret is protected against someone acquiring the knowledge by "improper" means. *Id.* Thus the proprietary right under a trade secret is not an exclusive property right in the information, but rather the right to protect one's information from improper appropriation. RESTATEMENT OF TORTS § 757 at 4. Droeger v. Welsh Sporting Goods Corp., 541 F.2d 790, 792 (9th Cir. 1976); Frances H. Shepard, Jr., 57 T.C. 600, 614 (1972), *rev'd* 481 F.2d 1399 (3d Cir. 1973) *cert. denied,* 417 U.S. 911 (1974); Junker v. Plummer, 320 Mass. 101, 67 N.E.2d 667, 670 (1946).

[132] The *Kewanee* Court quoted language from the leading case of A.O. Smith Corp. v. Petroleum Iron Works Co., 73 F.2d 531, 539 (6th Cir. 1934), *modified* 74 F.2d 934 (1935) which noted the function of trade secret law to protect one who makes a discovery, even if nonpatentable, from the competitive injury resulting from a "competitor who by unfair means, or as the beneficiary of a broken faith, obtains the desired knowledge without himself paying the price in labor, money, or mechanics expended by the discoverer." 416 U.S. at 482. This statement repeats a view expressed by the Supreme Court some seventy years before: "The plaintiff has the right to keep the work which it has done, or paid for doing, to itself. The fact that others might do similar work, if they might, does not authorize them to steal the plaintiff's." Chicago Bd. of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 250 (1905).

[133] As long as information is substantially secret it will support an action for misappropriation, *See* text accompanying note 139 *infra.* However, once information becomes a matter of general or public knowledge it cannot be a trade secret and any rights to protection are lost. RESTATEMENT OF TORTS § 757, at 5-6. 416 U.S. at 475.

[134] Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 474 (1974). Servo Corp. of Am. v. General Elec. Co., 393 F.2d 551, 555 (4th Cir. 1968). "It is the employment of improper means to procure the trade secret, rather than the mere copying or use, which is the basis of the liability under the rule stated in this section." RESTATEMENT OF TORTS § 757 at 3-4. *See* E.I. DuPont de Nemours Powder Co. v. Masland, 244 U.S. 100, 102 (1917); E.I. DuPont de Nemours & Co. v. United States, 288 F.2d 904, 910 (Ct. Cl. 1961); International

Consequently the Restatement expresses the broader majority rule of relative secrecy:[135]

> It is not requisite that only the proprietor of the business know it. He may, without losing his protection, communicate it to employees involved in its use. He may likewise communicate it to others pledged to secrecy. Others may also know of it independently, as, for example when they have discovered the process and formula by independent invention and are keeping it secret.[136]

In other words, contrary to the Service's stance in Revenue Procedure 69-19, the mere fact that an owner has licensed his secret to others,[137] or that others have independently discovered the secret,[138] does not destroy the owner's proprietary interest in preventing unauthorized disclosure or use of his secret. All that is required is that "a substantial element of secrecy . . . exist, so that, except by the use of improper means, there would be difficulty in acquiring the information."[139]

Admittedly, certain disclosures will destroy the element of

Indus., Inc. v. Warren Petroleum Corp., 99 F. Supp. 907, 913 (D. Del. 1951) *aff'd* 248 F.2d 696 (3d Cir 1957), *appeal dismissed*, 355 U.S. 943 (1958); Allen Mfg. Co. v. Loika, 145 Conn. 509, 144 A.2d 306, 309 (1958).

135 *See, e.g.*, Tri-Tron Int'l v. Velto, 525 F.2d 432, 436 (9th Cir. 1975); K-2 Ski Co. v. Head Ski Co., 506 F.2d 471, 473-74 (9th Cir. 1974); A.H. Emery Co. v. Marcan Products Co., 389 F.2d 11, 16 (2d Cir.), *cert. denied*, 393 U.S. 835 (1968); Republic Sys. & Programming, Inc. v. Computer Assistance, Inc., 322 F.Supp. 619 (D. Conn. 1970), *aff'd*, 440 F.2d 996 (2d Cir. 1971); Cudahy Co. v. American Labs. Inc., 313 F. Supp. 1339, 1343-44 (D. Neb. 1970); Plastic & Metal Fabricators, Inc. v. Roy, 163 Conn. 257, 303 A.2d 725 (1972); Town & Country House & Home Serv. Inc. v. Evans, 150 Conn. 314, 317-18, 189 A.2d 390, 393 (1963); Henkle & Joyce Hardware Co. v. Maco, Inc., 195 Neb. 565, 571, 239 N.W.2d 772, 776 (1976); R. MILGRIM, *supra* note 7, § 2.07[2].

136 RESTATEMENT OF TORTS § 757, at 6.

137 Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 475 (1974); Chicago Bd. of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 250-51 (1904).

138 The mere fact that others have obtained the information does not defeat its status as a trade secret. Thus one early opinion states:

> A "secret" is nothing more than a private matter; something known only to one or a few and kept from others. It may be acquired by lawful means, . . . without tracing title to the originator, and when so acquired it does not necessarily cease to be a secret which may be protected from unlawful competition. Secrecy may be absolute or relative.

Kaumagraph Co. v. Stampagraph Co., 235 N.Y. 1, 138 N.E. 485, 487 (1923). *See* McKinzie v. Cline, 197 Or. 184, 252 P.2d 564, 567-68 (1953).

139 K-2 Ski Co. v. Head Ski Co., 506 F.2d 471, 473-74 (9th Cir. 1974); A.H. Emery Co. v. Marcan Prods. Co., 389 F.2d 11, 16 (2d Cir.), *cert. denied*, 393 U.S. 835 (1968); Basic Chems. Inc. v. Benson, 251 N.W.2d 220, 229 (Ia. 1977); Space Aero Prods. Co. v. R.E. Darling Co., 238 Md. 93, 109-10, 208 A.2d 74, 82, *cert. denied*, 382 U.S. 843 (1965); Sun Dial Corp. v. Rideout, 16 N.J. 252, 257, 108 A.2d 442, 445 (1954).

substantial secrecy required by the Restatement. In some instances, the public distribution and sale of a product will eliminate any trade secret claimed in its design.[140] The publication of a patent will also destroy the required element of secrecy.[141] Similarly, publication in trade magazines or the general availability of the information may destroy the secret.[142]

However, disclosure in and of itself will not preclude protection of a trade secret unless that disclosure renders "meaningless" the duty to maintain such information in confidence.[143] At bottom, the issue is whether the information remains secret to the

[140] Koehring Co. v. E.D. Etnyre & Co., 254 F. Supp. 334, 361 (N.D. Ill. 1966); Houser v. Snap-On Tools Corp. 202 F. Supp. 181, 187 (D. Md. 1962); Speciner v. Reynolds Metal Co., 177 F. Supp. 291, 296 (S.D.N.Y. 1959), *aff'd,* 279 F.2d 337 (2d Cir. 1960); Bimbo Mfg. Co. v. Starz Cylinder Co., 119 Ill. App. 2d 251, 256 N.E.2d 357, 364 (1969). *See* Skoog v. McCray Refrigerator Co., 211 F.2d 254, 257 (7th Cir. 1954) (public display of innovation). But this result follows only when the claimed secret can be easily discovered from inspection of the product. Smith v. Dravo Corp., 203 F.2d 369, 374 (7th Cir. 1953). Thus, *Dravo* in finding a trade secret commented: "Here was no simple device, widely circulated, the construction of which was ascertainable at a glance." *Id.* at 375. *See* Kubik Inc. v. Hull, 56 Mich. App. 335, 224 N.W.2d 80, 93 (1974); K & G Tool & Service Co. v. G & G Fishing Magnets, Inc., 58 Tex. 594, 314 S.W.2d 782, 787, *cert. denied,* 358 U.S. 898 (1958).

[141] Once a patent is granted, all the details of the invention are published and secrecy is lost. Thus a trade secret action cannot be maintained for appropriations after that date. Scharmer v. Carrollton Mfg. Co., 525 F.2d 95, 99 (6th Cir. 1975). However, if the secret is appropriated before the patent is published, even though the patent is later published, most courts will nonetheless continue to recognize the trade secret action. *See, e.g.,* Engelhard Indus., Inc. v. Research Instrumental Corp., 324 F.2d 347, 352 (9th Cir. 1963), *cert. denied,* 377 U.S. 923 (1964); Shellmar Prods. Co. v. Allen-Qualley Co., 87 F.2d 104 (7th Cir. 1936), *cert. denied,* 301 U.S. 695 (1937); Julius Hyman & Co. v. Velsicol Corp., 123 Colo. 563, 233 P.2d 977 (1951); Adolph Gottscho, Inc. v. American Marking Corp., 18 N.J. 467, 114 A.2d 438 (1955); Hyde Corp. v. Huffines, 158 Tex. 566, 314 S.W.2d 763, *cert. denied,* 358 U.S. 898 (1958).

[142] Pressure Science Inc. v. Kramer, 413 F. Supp. 618, 626 (D. Conn. 1976), *aff'd,* 537 F.2d 301 (1977), aff'd 551 F.2d 301; Ferranti Electric Inc. v. Harwood, 43 Misc. 2d 533, 251 N.Y.S.2d 612 (1964). But the disclosure must destroy the value of the secret. Pressed Steel Car Co. v. Standard Steel Car Co., 210 Pa. 464, 60 A. 4, 9 (1904); A.H. Emery Co. v. Marcan Prods. Co., 388 F.2d 11, 16 (2d Cir. 1968). "Absolute secrecy is not essential and the plaintiff does not abandon his secret by delivering it or a copy to another for a restrictive purpose, nor by a limited publication." Plastic & Metal Fabricators, Inc. v. Roy, 163 Conn. 257, 303 A.2d 725, 731 (1972).

[143] Servo Corp. of America v. General Electric Corp., 393 F.2d 551, 555 (4th Cir. 1968); Wilkes v. Pioneer Am. Ins. Co., 383 F. Supp. 1135, 1140 (D.S.C. 1974).

> The fact that one secret can be discovered more easily than another does not affect the principle. Even if resort to the patterns of the plaintiff was more of a convenience than a necessity, still, if there was a secret, it belonged to him, and the defendant had no right to obtain it by unfair means, or to use it after it was thus obtained.

Tabor v. Hoffman, 118 N.Y. 30, 23 N.E. 12, 13 (1889).

extent that it retains a competitive value. Information may have been discovered by others, or disclosed to others; yet despite this "publication" the information may continue to provide the "possessor a commercial advantage over his competitors. This advantage constitutes value, and the disclosure of the information which creates the advantage may be sufficient to raise the implied agreement not to appropriate it."[144]

The possessor's competitive advantage derives principally from the effort that a competitor would have to expend in order to obtain the same knowledge.[145] Thus, in assessing the impact of disclosure on the viability of a secret, the proper question is not whether the disclosure makes the secret discoverable, but rather, whether an effort is still required in order to discover the secret. As a result, in evaluating a trade secret it is not determinative that one could develop or deduce the secret by examining published materials[146] or through one's own experimentation.[147] Nei-

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[144] Kamin v. Kuhnau, 233 Or. 139, 374 P.2d 912, 917 (1962).

[145] "[T]he mere fact that [a means of] lawful acquisition is available does not mean that he may, through a breach of confidence, gain the information in usable form and escape the efforts of inspection and analysis." Smith v. Dravo Corp., 203 F.2d 369, 375 (7th Cir. 1953). Similarly, in holding that know-how reduced to blueprints constituted a trade secret, one court states: "To be secret means that a blueprint, for example, is not in the public domain through divulgence and that it is not too easily discoverable; that is, apparent to all without too much hard work." Schulenburg v. Signatrol, Inc., 50 Ill. App. 2d 402, 200 N.E.2d 615, 618 (1964). *See* Telex Corp. v. I.B.M. Corp., 367 F. Supp. 258 (N.D. Okla. 1973), *modified*, 510 F.2d 894 (10th Cir.), *cert. denied*, 423 U.S. 802 (1975); *see also* Imperial Chem. Indus., Ltd. v. National Distillers & Chem. Corp., 342 F.2d 737, 743 (2d Cir. 1965).

[146] "It matters not that defendants could have gained their knowledge from a study of the expired patent and plaintiffs' publicly marketed product. The fact is that they did not. Instead they gained it from plaintiffs via their confidential relationship and in so doing incurred a duty not to use it to plaintiffs' detriment." Franke v. Wiltschek, 209 F.2d 493, 495 (2d Cir. 1953).

In Ellicott Mach. Corp. v. Wiley Mfg. Corp., 297 F. Supp. 1044 (D. Md. 1969) the court found that a trade secret existed despite the fact that one could have discovered the secret "by expending a considerable amount of time in the inspection of Ellicott dredges and by searching catalogues and brochures issued over a period of years by various suppliers." Where a combination of information is not itself a matter of public knowledge, the fact that one can piece together the knowledge through the disclosed pieces does not destroy the trade secret. *Id.* at 1052-53. *See* note 145 *supra* and accompanying text; Franke v. Wiltschek, 209 F.2d 493, 495 (2d Cir. 1953).

[147] International Indus. v. Warren Petroleum Corp., 99 F. Supp. 907, 913 (D. Del. 1951), *aff'd*, 248 F.2d 696 (3d Cir. 1957), *appeal dismissed*, 355 U.S. 943 (1958); Minnesota Mining & Mfg. Co. v. Technical Tape Corp., 23 Misc. 2d 671, 192 N.Y.S.2d 102, 119 (1959); Schavior v. American Rebonded Leather Co., 104 Conn. 472, 133 A. 582, 583 (1926).

ther will the mere marketing of a product destroy the underlying trade secret if one must "reverse engineer" in order to discover that product.[148] Similarly, it is no defense in a misappropriation action to assert that "the information embraced in each secret could have been discovered by diligent research or could have been ascertained by restoring to sources which the defendant never explored, such as testimony in prior litigation or the examination of expired patents, or by resorting to an article in a trade magazine. . . ."[149] In other words, by affording protection to all information which provides a competitive advantage, the Restatement ignores the issue of who knows or could know the information. Rather, the crucial issue becomes who does not know the "secret." If enough people remain in ignorance so that the information retains competitive value the information will be protected, and therefore should represent property for taxing purposes.[150]

Even disregarding the impact of the Restatement, the 1961 Court of Claims decision, *E.I. DuPont de Nemours & Co. v. United States*,[151] should bind the Service to the relative secrecy doctrine. *DuPont* defined trade secret to include "any information not generally known in the trade . . . . The information is frequently in the public domain . . . . *A plurality of individual discoverers may have protectible, wholly separate rights in the same trade secret.*"[152] Having so established the breadth of the

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> By measuring the component parts, they say, blueprints could have been prepared and the most efficient productive method deduced. The fact remains, however, that the defendants took unwarranted advantage of the confidence which the Schreyers reposed in them and obtained the desired knowledge without the expenditure of money, effort and ingenuity which the experimental analysis of the model on the market would have required. Such an advantage obtained through breach of confidence is morally reprehensible and a proper subject for legal redress.

Schreyer v. Casco Prods. Corp., 97 F. Supp. 159, 168 (D. Conn.), *modified*, 190 F.2d 921 (2d Cir. 1951), *cert. denied*, 342 U.S. 913 (1962).

[148] *See* note 140 *supra;* R. MILGRIM, *supra* note 7, § 2.05[3]; Cavitch, *supra* note 7, § 232.01[5].

[149] Minnesota Mining & Mfg. Co. v. Technical Tape Corp., 23 Misc.2d 671, 192 N.Y.S.2d 102, 116 (1959).

[150] See the discussion of *Kewanee* at text accompanying notes 111-119 *supra*, and the discussion of relative secrecy at text accompanying notes 134-139 *supra*.

[151] E.I. DuPont de Nemours & Co. v. United States, 288 F.2d 904 (Ct. Cl. 1961).

[152] Id. at 911. In a similar case involving capital gains treatment of trade secrets, Francis H. Shepard, 57 T.C. 600, 617-18 (1972), *rev'd without opinion*, 481 F.2d 1399 (3d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974), the court quoted extensively from *Tabor v.*

trade secret concept, *DuPont* concluded that trade secrets become property for purposes of the capital gains sections of the Code because, like patents, a trade secret affords its owner a "means to competitive advantage."[153] The court further noted, however, that with trade secrets, unlike patents, one's competitive advantage derives not from absolute rights but from one's right to prevent unauthorized disclosure of the secret;[154] thus, if the information is sufficiently secret to support a claim of misappropriation it will be property for the purposes of the Internal Revenue Code. This conclusion is in marked contrast to the Service's position that the secret can only be known by the employer and those employees with a need to know.

B. *Must the Information Be Unique, Novel and Original?*

The Service's requirement that the information be in the nature of an "invention" cannot withstand attack once the preeminence of the concept of competitive advantage is established. Again the Service fails to draw the distinction between the absolute rights of patents and the relative rights of trade secrets. Since a patent grants the owner an absolute monopoly and precludes ownership rights in others who may independently discover the invention, the invention must in fact be a clear advance in technology in order to warrant such an exclusive property interest.[155] Specifically, the invention must be original, unique, and novel.[156] However, since a trade secret constitutes something of value sufficient to support a claim of breach of confidence, inventiveness becomes a meaningless standard of assessment.[157] Rather, the correct approach is to determine if the information is an "advance" in technology sufficient to provide its owner with a competitive advantage.[158] If the discovery has such a competi-

Hoffman, supra note 143, to support the conclusion that the disclosure must place the information in the public domain before one's secret (*i.e.* property) is destroyed.

[153] *Id.*; Stalker Corp. v. United States, 209 F. Supp. 30, 33 (E.D. Mich. 1962).

[154] 288 F.2d at 911-12; Stalker Corp. v. United States, 209 F. Supp. at 34. *See* Francis H. Shepard, Jr., 57 T.C. 600, 616-18 (1972), *rev'd without opinion* 481 F.2d 1399 (3d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974).

[155] The requirements of novelty and invention "are essential to patentability because a patent protects against unlicensed use of the patented device or process even by one who discovers it properly through independent research." RESTATEMENT OF TORTS § 757 at 6-7.

[156] *See* 35 U.S.C. §§ 101-103 (1970).

[157] RESTATEMENT OF TORTS § 757 at 7.

[158] *See* text at note 119 *supra*.

tive value, then it must be a trade secret, and therefore should be property for purposes of section 351.[159]

The Service's test of invention, however, merely gives lip-service to this concept of trade secret. In Revenue Ruling 64-56 the Service states that the information need not be patentable.[160] In Revenue Procedure 69-19 the Service repeats this statement but nevertheless imposes a test of invention equivalent to that required for a patent: "[T]he 'information' [must] represent a discovery and, while not necessarily patentable, the 'information' [must be] original, unique, and novel."[161]

The additional requirement that the information be "original, unique, and novel" is totally contrary to the view espoused in the Restatement. The Restatement specifically states that the test of competitive advantage does not demand high standards of creativity. A trade secret need not be patentable;[162] novelty and invention are not required.[163] The information may be nothing more than something which is clearly anticipated in the prior art[164] or *"[information] which is merely a mechanical improvement that a good mechanic can make."*[165] Certainly,

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[159] As has been argued above, anything qualifying as a trade secret under the Restatement's definition must represent property, as required by *DuPont* and *Kewanee. See* text accompanying notes 111-119 *supra.* This conclusion is further reinforced by the earlier 1961 *DuPont* decision which broadly defines what may constitute a trade secret. *See* text accompanying notes 151-154 *supra.*

[160] Information need not be "patentable in the patent law sense." 1964-1 (Part 1) C.B. at 134.

[161] 1969-2 C.B. at 302.

[162] RESTATEMENT OF TORTS § 757, Comment b at 6.

[163] *Id. See, e.g.,* Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 476 (1974); University Computing Co. v. Lykes-Youngstown Corp., 504 F.2d 518, 535 n.25 (5th Cir. 1974); Kodekey Elec., Inc. v. Mechanex Corp., 486 F.2d 449, 455 (10th Cir. 1973); Clark v. Bunker, 453 F.2d 1006, 1009 (9th Cir. 1972); Water Serv., Inc. v. Tesco Chem. Inc., 410 F.2d 163, 172-73 (5th Cir. 1969); Monolith Portland Midwest Co. v. Kaiser Alum. & Chem. Corp., 267 F. Supp. 726, 731 (S.D. Cal. 1967), *modified,* 407 F.2d 288 (9th Cir. 1969); Seismograph Serv. Corp. v. Offshore Raydist, 135 F. Supp. 342, 354 (E.D. La. 1955), *modified,* 263 F.2d 5 (5th Cir. 1958); Sun Dial Corp. v. Rideout, 16 N.J. 252, 108 A.2d 442 (1954); Henkle & Joyce Hardware Co. v. Maco Inc., 195 Neb. 565, 239 N.W.2d 772, 776 (1976); Extrin Foods v. Leighton, 202 Misc. 592, 115 N.Y.S.2d 429 (1952); R. MILGRIM, *supra* note 7, § 2.08[2] and authorities cited therein at n.9.

[164] *See, e.g.,* E.W. Bliss Co. v. Struther-Dunn, Inc., 291 F. Supp. 890 (S.D. Ia. 1968); Sperry Rand Corp. v. Rothlein, 241 F. Supp. 549, 560 (D. Conn. 1964) Sinclair v. Aquarius Elec., Inc., 42 Cal. App. 3d 216, 116 Cal. Rptr. 654, 659 (1974); Mann v. Tatge Chem. Co., 201 Kan. 326, 440 P.2d 640, 647 (1968); Gallowhur Chem. Corp. v. Schwerdle, 37 N.J. Supr. 385, 117 A.2d 416, 421 (1955); Fairchild Engine & Airplane Corp. v. Cox, 50 N.Y.S.2d 643, 656 (S.Ct. 1944); R. MILGRIM, *supra* note 7, at § 2.08[3].

[165] RESTATEMENT OF TORTS § 757 at 7. A.O. Smith Corp. v. Petroleum Iron Works, Co.,

there must be some element of "discovery" involved so that the information contains an element of secrecy and thus provides the owner with a competitive advantage.[166] But this liberal standard of discovery is all that is required.[167]

Consequently, if the information in fact provides its owner with a competitive advantage, it does not matter if the "discovery" may appear to be simple or obvious.[168]

> Facts of great value may, like the lost purse upon the highway, lie long unnoticed upon the public commons. Hundreds pass them by, till one more observant than the rest makes the discovery. It is idle

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73 F.2d 531, 539 (6th Cir.), *modified*, 74 F.2d 934 (1934); Ranger Steel Prods. Corp. v. Chodak, 128 N.Y.S.2d 607, 610 (S. Ct. 1953); Kamin v. Kuhnau, 233 Ore. 139, 374 P.2d 912, 917 (1962); R. MILGRIM, *supra* note 7, § 2.08[3] at 2-94. *See* Sloan v. Mud Prods., 114 F. Supp. 916, 924-27 (N.D. Okla. 1953).

[166] "[S]ome novelty will be required if merely because that which does not possess novelty is usually known; secrecy, in the context of trade secrets, thus implies at least minimal novelty." Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 476 (1974). Hooker Chem. Corp. v. Velsicol Chem. Corp., 235 F. Supp. 412 (W.D. Tenn. 1964); Sarkes Tarzian, Inc. v. Audio Devices Inc., 166 F. Supp. 250, 265 (S.D. Cal. 1958) *aff'd per curiam*, 283 F.2d 695 (9th Cir. 1960), *cert. denied*, 365 U.S. 869 (1961).

[167] "Quite clearly discovery is something less than invention. Invention requires genius, imagination, inspiration, or whatever is the faculty that gives birth to the inventive concept. Discovery may be the result of industry, application, or be perhaps merely fortuitous. The discoverer, however, is entitled to the same protection as the inventor." A.O. Smith Corp. v. Petroleum Iron Works Co., 73 F.2d 531, 538 (6th Cir.), *modified*, 74 F.2d 934 (1934).

[168] The mere fact that the means by which a discovery is made are obvious, that experimentation which leads from known factors to an ascertainable but presently unknown result may be simple, we think cannot destroy the value of the discovery to one who makes it, or advantage the competitor who by unfair means, or as the beneficiary of a broken faith, obtains the desired knowledge without himself paying the price in labor, money, or machines expended by the discoverer.

A.O. Smith Corp. v. Petroleum Iron Works Co., 73 F.2d 531, 538-39 (6th Cir.), *modified*, 74 F.2d 934 (1934). *See* Franke v. Wiltschek, 209 F.2d 493, 499 (2d Cir. 1953); Forest Labs., Inc. v. Formulations, Inc., 299 F. Supp. 202, 208 (E.D. Wis. 1969), *modified*, 452 F.2d 621 (7th Cir. 1971); Mann v. Tatge Chem. Co., 201 Kan. 326, 440 P.2d 640, 647 (1968); Cavitch, *supra* note 7, § 232.01[6]; *see also* Cooper, *supra* note 46, at 335 (1966).

There are other variations to the same broad approach. For example, one court asks directly whether the discovery is simple and obvious in order to determine if the information provides a competitive advantage. K&G Oil Tool & Serv. Co. v. G&G Fishing Tool Serv., 158 Tex. 594, 314 S.W.2d 782, 790 (1958) (holding that a magnetic fishing tool represented a trade secret). California expresses a similarly broad standard: "[I]t has been held that a trade secret in the broad sense consists of any unpatented idea which may be used for industrial and commercial purposes." Sinclair v. Aquarius Elec., Inc., 42 Cal. App.3d 216, 116 Cal. Rptr. 654, 658 (1974) (holding that a portable device which converted brain waves into an audible signal was a mechanical improvement over existing stationary equipment and therefore was a trade secret.).

> to say that, in the eyes of the law, interest may not in such case follow discovery.[169]

The test of competitive advantage has been sometimes stated as "that modicum of originality which will separate it from everyday knowledge."[170] The broad concept of "modicum of originality" can hardly be compared with the Service's narrow demand that the information be original, unique, and novel.[171]

C. *Are Mere Experience and Mere Plant Design Property?*

Because the Service's "unique and novel" and "absolute secrecy" requirements fail to address the true property issue, the competitive value of the information, those factors which the Service has enumerated as guidelines for resolving these factual controversies also become meaningless standards. Among those items most concerning the Service in a section 351 know-how transfer,[172] the two most striking are mere knowledge or efficiency resulting from experience and information representing "assistance in the construction of a plant building . . . or advice as to the layout of plant machinery and equipment."[173] The Service will presume that these items constitute services.

Although admirably suited to the Service's design to expand the "services exclusion" under section 351 to its greatest possible breadth, these factors bear little relation to the Restatement's concern for competitive advantage. Certainly "mere" knowledge

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[169] A.O. Smith Corp. v. Petroleum Iron Works Co., 73 F.2d 531, 539 (6th Cir. 1934), *modified*, 74 F.2d 934 (1935).

[170] Cataphote Corp. v. Hudson, 444 F.2d 1313, 1315 (5th Cir. 1971), quoted in Forest Labs., Inc. v. Pillsbury Co., 452 F.2d 621, 624 (7th Cir. 1971). The test may be alternatively stated as that amount of "novelty" and "secrecy" necessary to make the knowledge commercially valuable. Atlantic Wool Combing Co. v. Norfolk Mills, Inc. 357 F.2d 866, 869 (1st Cir. 1966).

[171] The requirement "that the know-how 'represents a discovery and, while not necessarily patentable, the information is original, unique and novel,' is a serious deviation from trade secret law. Such a requirement imposes a standard of discovery which is not required by the courts, and which is contrary to controlling state common law under which trade secrets are recognized, as well as state court decisions governing trade secrets. *A more appropriate criteria for deciding whether 'property' has been transferred might be a determination of whether the conveyance of the know-how also conveys a competitive advantage on the transferee.*" J. BISCHEL, *supra* note 1, ¶ 6.3b[3], 6-23-6-24 (emphasis added). Nearly identical language can be found at R. MILGRIM, *supra* note 7, § 6.04[4] at 6-128.2.

[172] These factors are enumerated in Revenue Procedure 19, 1969-2 C.B. See note 182 *infra* for a discussion of those items not discussed in the text.

[173] Rev. Proc. 19, 1969-2 C.B. 302.

or efficiency resulting from experience can represent property within section 351 where that information amounts to a discovery, *i.e.* commercially valuable experience.[174] Perhaps the purest form of "mere experience" is a corporation's customer lists. In assessing whether such lists are trade secrets (and thus property), the courts have refused to impose requirements of novelty or absolute secrecy. Rather the courts examine such lists in terms of six factors set out in the Restatement, factors designed to assess whether the information provides a competitive advantage.[175]

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[174] Defendants contend that plaintiff's processes, methods and materials cannot be trade secrets, since they are known to and used by aircraft mechanics and engineers. This overlooks the fact that a *knowledge of the particular process, method or material which is most appropriate to achieve the desired result may itself be a trade secret.* So may a knowledge of the best combination of processes, methods, tools and materials.

Head Ski Co. v. Kam Ski Co., 158 F. Supp. 919, 923 (D. Md. 1958) (emphasis added). Space Aero Products Co., Inc. v. R.E. Darling Co., 238 Md. 93, 208 A.2d 74, 80, *cert. denied,* 382 U.S. 843 (1965). Thus, where experience is competitively valuable it will be given recognition as property: "The long experience of the plaintiffs enabled the defendant to efficiently equip its plant by the installation and use of several processes and devices, which although not patentable by the plaintiffs, yet were valuable additions to the equipment being installed." Reynolds Metals Co. v. Skinner, 166 F.2d 66, 75 (6th Cir.) *cert. denied,* 344 U.S. 858 (1948). *See also* B.F. Goodrich Co. v. Wohlgemuth, 117 Oh. App. 493, 192 N.E.2d 99 (1963).

[175] The Restatement specifically includes customer lists as potential trade secrets. § 757 at 5. The Restatement then enumerates the following factors to be considered in reviewing all potential trade secrets:

(1) the extent to which the information is known outside of his business; (2) the extent to which it is known by employees and others involved in his business; (3) the extent of measures taken by him to guard the secrecy of the information; (4) the value of the information to him and his competitors; (5) the amount of effort or money expended by him in developing the information; (6) the ease or difficulty with which the information could be properly acquired or duplicated by others.

RESTATEMENT § 757 at 6. Perhaps indicative of the difficult factual issues presented, the courts have been particularly willing to apply these factors to specifically consider whether customer lists will qualify as trade secrets. Republic Sys. & Programming, Inc. v. Computer Assistance, Inc., 322 F. Supp. 619, 628 (D. Conn. 1970), *aff'd,* 440 F.2d 996 (2d Cir. 1971); Cudahy Co. v. American Laboratories, Inc., 313 F. Supp. 1339, 1343 (D. Neb. 1970); Basic Chem., Inc. v. Benson, 251 N.W.2d 220, 226 (Ia. 1977); Jet Spray Cooler, Inc. v. Crampton, 361 Mass. 835, 282 N.E.2d 921, 925 (1972); Abbott Labs. v. Norse Chem. Corp., 33 Wisc.2d 445, 147 N.W.2d 529, 538-39 (1967).

It is noteworthy that the Restatement makes no reference to "mere experience"; rather, the factors recited above specifically assess the competitive value of the information. If "mere experience" satisfies the competitive advantage test, it will be protected as a trade secret. *See* Ashland Oil, Inc. v. F.T.C., 409 F. Supp. 297, 303 (D.D.C.), *aff'd,* 548 F.2d 977 (D.C. Cir. 1976), which applied the same six factors of the Restatement to rule

Thus, the courts will protect customer lists where substantial effort by a competitor would be required in order to duplicate the information.[175]

In fact, customer lists specifically illustrate the distorted construction of "property" which the Service advocates for section 351. For purposes of section 162[176] the Service readily maintains that customer lists represent "property" which must be capitalized rather than expensed in the year of purchase. The courts have unquestionably adopted the view that customer lists are property; the only issue is whether they are amortizable property under section 167[177] of the Code.[178] Since customer lists are "property," and since a customer list can be nothing but someone's accumulated "experience," how can the Service maintain

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that Ashland's gas reserves estimates were trade secrets for purposes of the federal Freedom of Information Act; United States v. Frazell, 335 F.2d 487, 490 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965), which ruled, without discussion, that oil maps were property for purposes of section 351.

[175] *See, e.g.*, Basic Chem., Inc. v. Benson, 251 N.W.2d 220, 229 (Ia. 1977); Heyman v. A.R. Winarick, Inc., 325 F.2d 584, 590 (2d Cir. 1963). *See also* the exhaustive discussion of customer lists in Annot., 28 A.L.R.3d 7 (1969).

[176] Section 162(a) provides that "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." Treas. Reg. § 1.162-1 states in part that a business expense deduction will not be granted to the extent that an item "is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property." Where an asset acquired for one's trade or business has a useful life in excess of one year, it is generally deductible under section 162. *See, e.g.*, Manhattan Co. of Va., 50 T.C. 78, 86 (1968); Richard M. Boe, 35 T.C. 720, 725 (1961), *aff'd*, 307 F.2d 339 (9th Cir. 1962).

[177] Section 167 states the rules concerning the depreciation deduction allowable for property used in a trade or business, or property held for the production of income. Treas. Reg. § 1.167(a)-3 provides that an intangible asset can be depreciated where it has a limited useful life "which can be estimated with reasonable accuracy." Notably, the most "intangible" of assets, goodwill, although not depreciable due to its indefinite life, is nonetheless considered "property" within the meaning of section 167. Treas. Reg. 1.167(a)-3; *see, e.g.*, Comm'r v. Killian, 314 F.2d 852 (5th Cir. 1963); Robert B. Tomlinson, 58 T.C. 570 (1972);Edward A. Kenney, 37 T.C. 1161 (1962).

[178] The following commercial lists were granted property status for the purpose of section 167: a list of fuel oil customers, Sunset Fuel Co. v. United States, 519 F.2d 781 (9th Cir. 1975) and Holden Fuel Oil Co., 31 T.C.M. (CCH) 184 (1972); newspaper subscription lists, Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973); cable television customer lists, General Tele., Inc. v. United States, 77-2 U.S.T.C. (CCH) ¶ 9688 (D. Minn. 1977); laundry service customer lists, National Serv. Indus., Inc. v. United States, 379 F. Supp. 831 (N.D. Ga. 1973) and Manhattan Co. of Va., 50 T.C. 78 (1968); credit information files, Computing & Software, Inc., 64 T.C. 223 (1975); and a pharmacy prescription file, Grant T. Rudie, Jr., 49 T.C. 131 (1967).

that something which is "mere experience" is presumptively not property?

In the same fashion, advice as to plant construction or the lay out of machinery may also represent property where such advice concerns knowledge not in the public domain, knowledge that will afford the transferee an advantage over competitors who lack the benefit of such advice. Certainly the design of a manufacturing process, in some instances necessarily including plant design and the lay-out of machinery, qualifies as a trade secret where the discovery test is met.[179] Even the most abstract forms of production designs, or lay-outs, such as marketing techniques[180] or computer programs,[181] are granted trade secret protec-

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[179] It is also of no consequence that the elements of the process or design are all of public knowledge. "[A] trade secret can exist in a combination of characteristics and components, each of which, by itself, is in the public domain, but the unified process, design and operation of which, in unique combination, affords a competitive advantage and is a protectable secret." Imperial Chem. Indus. Ltd. v. National Distillers & Chem. Corp., 342 F.2d 737, 742 (2d Cir. 1965). In other words, this combination of known processes will be a trade secret "if the combination of the interrelated parts represented a valuable contribution arising from plaintiff's independent efforts." Ferroline Corp. v. General Aniline & Film Corp., 207 F.2d 912, 921 (7th Cir. 1953) *cert. denied*, 347 U.S. 953 (1954). *See, e.g.*, Head Ski Co. v. Kam Ski Co., 158 F. Supp. 919, 923 (D. Md. 1958); Space Aero Prods. Co., Inc. v. R.E. Darling Co., 238 Md. 93, 208 A.2d 74, 80 (1965); Cavitch, *supra* note 7, § 232.01[3]. *See also* Eastern Marble Prods. Corp. v. Roman Marble, Inc. 364 N.E.2d 799 (Mass. 1977).

[180] For example, in Clark v. Bunker, 453 F.2d 1006 (9th Cir. 1972) plaintiff developed a marketing scheme for prepaid funeral services plans. Defendant alleged that he could not have misappropriated the scheme as it was not a trade secret. In the first instance the scheme was to a great degree based on elements of other marketing programs already of public knowledge. And secondly, the scheme had been sold to or discussed with a number of others in the mortuary business and therefore was no longer secret.

The court rejected both arguments. Even though the plan was not unique and novel the district court had found that the plan afforded plaintiff a marked advantage over competitors, and was therefore a trade secret. Similarly, the disclosures of the plan did not defeat its status as a trade secret since "[s]ubstantial effort would be required to assemble the detailed elements of the plan from publicly available sources." *Id.* at 1010.

The court in Wilkes v. Pioneer Am. Ins. Co., 383 F. Supp. 1135 (D.S.C. 1974), granted similar trade secret protection to a scheme for marketing life insurance. The court commented: "The forms and plans consisted of a combination of many commonly used practices, but were combined in a way that had not been used before, and gave plaintiff a marked advantage over competitors." *Id.* at 1139. Thus where a business design provides a competitive advantage, that design will be a trade secret and thus property for purposes of section 351.

Equally applicable to "mere efficiencies" and "advice as to plant construction," the Restatement broadly recognizes any commercial practice as potentially a trade secret. Thus a trade secret may "relate to the sale of goods or to other operations in the business, such as a code for determining discounts, rebates or other concessions in a price list or tion where substantial effort would be required to duplicate the information. Since these items receive trade secret protection, they should also represent property for the purposes of section 351 as well. Once again the key test is not whether the transfer takes on the appearance of a service, but rather whether the knowledge transferred supplies the transferee with a competitive advantage over those who do not possess the knowledge.[182]

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catalogue, or a list of specialized customers, or a method of bookkeeping or other office management." § 757(b) at 5.

[181] In Rev. Proc. 36, 1974-2 C.B. 491, the Service cast a shadow on computer programs as property under section 351 when it stated that computer software would be judged as property according to the onerous conditions enumerated in Revenue Procedure 69-19. *See* Flyer & Buell, *supra* note 4, at 27-29 for an argument that computer software would likely not qualify as property if the Service applied a narrow definition to Revenue Ruling 64-56.

Although there is little direct authority on point, it seems evident that the same test of competitive advantage will also apply to computer software in determining if an element of "property" exists in the program. *See* Bender, *Trade Secret Protection of Software*, 38 GEO. WASH. L. REV. 909 (1970). In Structural Dynamics Research Corp. v. Engineering Mechanics Research Corp., 401 F. Supp. 1102 (E.D. Mich. 1975), the court avoided the specific issue of whether a computer program was a trade secret by finding that there was no misappropriation in that defendants themselves had developed the program. The court, nonetheless, held defendants liable for breaching their express contract not to disclose confidential information:

> The technical planning and development of NIESA [the program] to its stage of development in January, 1973, including the selection of elements, solver routine, organization of sub-routines, coding, and other factors contributing to the efficiency and effectiveness of the program constituted important and confidential information, particularly prior to public release of the program. The technical accomplishments of Surana and Kothwala reflected in their work on NIESA *amounted to a compilation of information which gave SDRC a competitive advantage. The existence or availability of abstract technical data does not detract from the confidentiality of the combination of such parts and data into a program of the type under consideration.*

Id. at 1116 (emphasis added).

In University Computing Co. v. Lykes-Youngstown Corp., 504 F.2d 518 (5th Cir. 1974) the misappropriation involved a retail inventory control system consisting of both computer hardware and software. Unfortunately the court made little effort to distinguish between the hardware and the software, instead addressing the computer "system." Nonetheless, it appears that the misappropriation at issue was predominantly, if not entirely, a theft of the software. *Id.* at 529 & n.6. Relying on the Restatement, the court stated that novelty was not required. Thus the system was a trade secret since it "had unique capabilities and features which make it a valuable competitive product." *Id.* at 535.

For an analysis of the reasons for granting patent protection to computer software, *see, e.g.*, Note, *Patentability of Computer Software: The Nonobviousness Issue*, 62 IOWA L. REV. 615 (1976).

[182] The Service also presumes that the following will not qualify as section 351 property:

D. *Is the "Incident to" Test the Restatement in Disguise?*

Even the Restatement may define property for section 351 purposes too narrowly. The court in *DuPont* stated the test as whether the transfer would confer a benefit, whether the information constitutes a positive business asset;[183] *Stafford* defined prop-

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(1) Training of the transferee's employees which is essentially educational in nature. Like the Service's distaste for mere knowledge or efficiency resulting from experience, the proper question is not whether the knowledge resulted from experience or whether the knowledge is training of employees; rather, the Service must ask if the knowledge provides the transferee a competitive advantage. If the knowledge is of such value then it must be property regardless of whether it was conveyed in the form of "training." *See* text accompanying notes 111-119 *supra.*

(2) Future transfers of information, such as new developments, and (3) information developed especially for the transferee. Both of these prohibitions appear to be carryovers from concepts peculiar to the capital gains sections. To qualify for capital asset status, the property must be held by the taxpayer for the prescribed period and cannot constitute property held "primarily for sale to customers in the ordinary course of his trade or business . . . ." I.R.C. § 1221. Thus transfers of property to be created, or property developed for the purpose of sale, would apparently not represent a "capital asset." *But see* text accompanying notes 103-104 *supra.*

Section 351, however, requires only that "property" be transferred; 351 contains no requirements that property must also qualify as a "capital asset." The *DuPont* decision discussed in the text accompanying notes 226-230 *infra* expressly rejected this analogy between section 1221 capital asset and section 351 property. Consequently, future transfers of information developed specifically for the transferee must also qualify as property for section 351, at least where that information meets the Restatement test of competitive advantage.

(4) Information which is merely "the rights to tangible evidence of information such as blueprints, drawings or other physical material on which it is recorded." If the Service, by this statement, is requiring that the transferor convey the knowledge to implement the plans along with the plans themselves in order for the transfer to qualify as a property transfer, the Service's position apparently contradicts its statements that mere experience and mere training cannot constitute property. If the Service is stating that blueprints and drawings are not property, the Service has adopted a position directly contrary to unquestioned authority indicating that quite often blueprints and drawings are protected trade secrets. *See, e.g.*, Smith v. Dravo Corp., 203 F.2d 369 (7th Cir. 1953); Tabor v. Hoffman, 118 N.Y. 30, 23 N.E. 12 (1889); R. MILGRIM, *supra* note 7, § 2.09[6] and authorities cited therein.

(5) Finally, the Service presumptively denies property status to information which is revealed by a patent, is the subject of a patent application, or is disclosed by the product on which it is used or to which it is related. It is true that there can be no trade secret in information which is revealed in a patent. However, while the information remains in the form of a patent application trade secret protection is granted where the competitive advantage test is met. R. MILGRIM, *supra* note 7, § 2.06[2], at 2-61 and authorities cited at n.20; text accompanying notes 1-47 & 51 *supra.* The Service's statement that the information cannot be disclosed by the product states the obvious. However, in applying this rule one must recall that disclosure is judged by the permissive concept of competitive advantage, not the more stringent requirements of absolute secrecy. *See* text accompanying note 148 *supra.*

[183] *See* text accompanying notes 34-37 *supra.*

erty in terms of what could be possessed, used, or transferred.[184] In 1955 even the Service apparently adopted this broad view. After stating that know-how is a right akin to secret processes and secret formulas, the Service defined know-how as "something that its possessor can grant to another for consideration."[185] Similarly, some courts assess the factual issue of competitive advantage by examining whether the information has value on the open market, i.e., whether the information is a positive business asset.[186] Know-how which represents a "business asset," or know-how which can be "transferred for consideration" may be but two different expressions of the same test of competitive advantage. All that should matter for tax purposes, however, is that the potentially broader concept of business asset is the standard applicable in transfers of know-how under section 351.

In practical effect, the "business asset" and "transferred for consideration" tests have been what the courts have in fact been using with respect to know-how transfers under section 351. Rather than expressly adopting these broad definitions of property for know-how purposes, the courts have found it easier to expand the Service's interpretation of the "ancillary and subsidiary to" exception, applying broader "incident to" language. However, the standard employed for defining "incident to" is the same business value concept endorsed by *DuPont* and recognized by the Restatement.[187]

For example, *Mineral Products Co.* recognized written instructions concerning the use of formulas, processes, and procedures, consulting services, and future communications as to developments in the field as property under the "incident to" excep-

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[184] *See* text accompanying note 39 *supra*.

[185] Rev. Rul. 17, 1955-1 C.B. 389. This ruling, however, was not issued for the purposes of defining property for section 351, but rather to make the distinction between property and services for the purpose of determining royalty income. A similarly broad definition of intangible property is advocated by the Service in Regulation 1.482-2(d)(3) quoted in note 43 *supra*.

[186] "The difficulty of securing the necessary details except by unlawful means is evidenced by the substantial sum ($55,000) paid to appellee for a corporation which appellee had formed to use the plan . . . ." Clark v. Bunker, 453 F.2d 1006, 1010 (9th Cir. 1972). *See, e.g.*, Extrin Foods v. Leighton, 202 Misc.2d 592, 115 N.Y.S.2d 429, 435 (1952).

[187] One author has already noted that use of a broad definition of know-how as property would eliminate the need for the "ancillary and subsidiary" rule. *Cooper, supra* note 46, at 335.

tion. Specifications, quality-control procedures, and test data were necessary for the effective utilization of the transferred formulas, and were, therefore, implicitly business assets. Other information concerning sales, cost estimating, and application techniques was also designated as property. In language strongly reminiscent of a court applying the Restatement, the Tax Court noted: "Even though much of the material was available to competitors, it constituted valuable marketing information, developed through practice, which was oriented toward the particular properties of the CAFCO products and which could be obtained from no other source."[188]

Additionally, in *Bell*, production know-how, including engineering and manufacturing data, was granted property status because they were "incident to" the patents. The court noted, however, that the know-how conveyed "did not depend upon reference to the patent drawings[189] and was thus somewhat independent of the patents. Apparently, what justified the treatment of this know-how as property was not so much the integral relationship between the know-how and the patents as it was the unquestioned competitive value of the know-how transferred.[190]

Finally, *Gable* expressly minimizes the distinction between patents and know-how. The *Gable* court stated that the "incident to" exception was but "the recognition that a patent transfer is, in large part, a transfer of knowledge."[191] Know-how that "relates to" the patents transferred, *i.e.* know-how that assists the buyer "in implementing the acquired knowledge and in developing its full potential," may be just as valuable as the patents themselves.[192] *Gable* implies that know-how "related to" the transfer

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[188] 52 T.C. at 199. The court also found that the design of a device used to measure the bulk density of fibers was a capital asset as the evidence indicated "that it was not known to the trade." The parties to the contract transferring the asset had labelled the device as know-how. *Id.* at 198.

[189] 381 F.2d at 1020.

[190] "By virtue of the agreement with Bell, Agusta received the benefit of the FAA certification and obtained engineering know-how . . . which enabled it to build a small replica of the Bell Fort Worth plant and to enter into the helicopter business without the years of research and development and the expenditure of the millions of dollars which Bell had been required to spend in order to develop this over-all helicopter know-how."

Id.

[191] 33 T.C.M. (CCH) at 1433.

[192] *Id.*

of proprietary information constitutes property, even though it strongly resembles services.[193] Viewed in this fashion, the "incident to" exception is little more than the business asset test adapted to the specific context of transfers of packages of technology.

E. *Does The Broad Concept of Property Permit the Taxpayer a Choice of Law?*

As noted in the historical analysis of section 351 above, there has never been any question as to whether know-how will qualify as property. Rather, the issue left unresolved is *what forms* of know-how will qualify as property. In initial attempts to resolve this issue, the courts and the Service have taken divergent paths. Opinions analyzing section 351 indicate that the term "property" is to be given its broadest construction. Similarly, courts discussing know-how as property under sections 1231 and 1235 reveal that the "services exclusion" is to be applied to know-how sparingly, if at all. The Service, however, persists in expanding the concept of "services" to its maximum limits, while narrowly defining what forms of know-how qualify as property. Because of the broad definition given property under the decisions in *DuPont* and *Stafford,* the Service's position must yield to the more lenient standards of the Restatement, a definition of property endorsed by the Supreme Court in *Kewanee* and implicitly recognized by courts applying the "incident to" exception for services.

However, as also noted above, *DuPont* and *Stafford* may stand for a broader concept of property than that expressed by the Restatement. This conclusion is of particular importance with respect to international transfers where the taxpayer faces the additional issue of whose law of competitive advantage will determine whether a particular form of know-how will be granted property status. Revenue Ruling 64-56 states that the information must be given substantial protection in the country in which the transferee is to operate.[194] Revenue Procedure 69-19 incorporates

[193] Thus the court granted capital asset status to transfers of future know-how as well, based upon the value of this information in assisting the complete use of the patents transferred. These future transfers were so related to the underlying patent rights that even though not yet in existence, they would be granted capital asset status in defiance of the requisite holding period. *Id.* at 1433-34. For a similar result, see Heil Co. 38 T.C. 989, 1003 (1962) discussed at text accompanying notes 73-78 *supra,* and PPG Industries, 55 T.C. 928, 1018 (1970) discussed at text accompanying notes 89-91 *supra.*

[194] Rev. Rul. 56, 1964-1 (Part I) C.B. 133.

by reference the rules expressed in Revenue Ruling 64-56, and expressly repeats the requirement that the information be substantially protected in the country in which it is to be used. However, in a somewhat contradictory fashion, the Procedure later requires that the information be property within the meaning of Revenue Ruling 64-56 *and* that it be protected under the laws of the country *from* which it is being transferred.[195] To comply with the United States law, the information must meet the absolute secrecy and "unique and novel" tests already discussed. The Procedure then concludes that if these requirements are met, the information will be deemed to be protected under the laws of the transferee country as well, for the purposes of satisfying the advance ruling requirement of section 367. Significantly, the Service does not state whether this assumption is rebuttable, that is, whether the Service can later challenge a transfer under section 351 as not being protected under the law of the transferee country, even though the requirements for a pre-transfer 367 ruling have been met. Although the change under section 367 to post-transfer rather than pre-transfer rulings implemented by the Tax Reform Act of 1976 may eventually eliminate this ambiguity by eliminating the need for pre-transfer evaluation, at present the Service's statements indicate a willingness to evaluate "property" under the laws of *both* the transferor and transferee countries.[196]

Such fence-straddling by the Service ignores the courts' broad definition of property. If any person is to be permitted a "choice of law," it should be the taxpayer not the Service. The Service is justified in relying on United States law where the law of the transferee country is in substantial doubt or has yet to develop.[197] Nonetheless, in applying transferor country law the

[195] Rev. Proc. 19, 1969-2 C.B. 302.

[196] Rev. Proc. 69-19 concludes by stating that "these procedures have no effect upon the substantive provisions and requirements of Revenue Ruling 64-56." 1969-2 C.B. at 302. *But see* Flyer & Buell, *supra* note 4, for an argument that satisfying Revenue Procedure 69-19 necessarily satisfies the "protection under the laws of the transferee" requirement of Revenue Ruling 64-56.

[197] Illustrative of the potential uncertainties of foreign law regarding know-how in even the most highly developed countries see the discussion in A. WISE, TRADE SECRETS AND KNOW-HOW THROUGHOUT THE WORLD (1974), Vol. 1, § 1.04[1] (Belgium) (1976); Vol. 3, § 3.06 (France) (1974); Vol. 3, § 4.02[4] (Germany) (1974); Vol. 4, § 5.01[3] (Italy) (1974).

Because foreign law can create confusion, one might do better to address whether the

Service should employ the proper interpretation of that law, *i.e.* the liberal standards of the Restatement. Know-how which meets the Restatement's competitive advantage test will be protected in the United States, at least in Restatement jurisdictions. Therefore that information must represent "property" within the broad business asset concept expressed in *DuPont*. Taken one step further, since *DuPont* defines property only in terms of "positive business assets," not in terms of "protected business assets," once the Restatement has been satisfied, the information need no longer be judged against the protection rules employed by the transferee country. A recognized "asset" has been transferred, even though that asset may not qualify as protected property under stricter rules of foreign jurisdictions.

Conversely, what if a transferee nation employs broader rules than those expressed in the Restatement?[198] Will the taxpayer be permitted to employ this broader definition of property? If the transferee can protect his information in his country of business, it becomes irrelevant under the business asset test whether that information was also protected in the United States. If the transferee can protect the information, then clearly a valuable asset was transferred; the transferee has received a right capable of ownership, use, or disposition and, therefore, has received property under the definition expressed in *Stafford*. Indeed, if one law is to govern to the exclusion of the other, logic dictates that the law of the transferee nation control.[199] *DuPont* and *Stafford* pre-

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information would be recognized as capable of supporting a contract for royalties, rather than whether the information is property in and of itself. For example, although in France the property law of information is in doubt, Wise's summary of one French case addressing the royalty issue yields the very Restatement definition employed in the United States:

> By providing an industrial establishment with processes or techniques unknown to it, and which it could learn only through a considerable outlay of research and development expenditure and after the lapse of some time and effort, the licensor has provided the licensee with an appreciable advantage for which it may exact a royalty. This is so even if the particular process or technique is not secret.

3 A. WISE, *supra*, § 3.06[4], at 3-76 to 3-77 (1974).

[198] As a possible example of a standard broader than the Restatement, see 1 A. Wise, *supra* note 197, § 4.02[2] (1976), indicating that certain "technical skill" will receive property protection in the Republic.

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> Because, in the case of transfer of the right to use a secret formula or process in a foreign country, the laws of the foreign country are determinative of the nature of the right being transferred, reference to the laws of the country of the transferor would seem to be inappropriate.

Flyer & Buell, *supra* note 4, at 27.

clude the Service from applying the laws of both the transferee and transferor nations.

III. WHAT CONSTITUTES A TRANSFER FOR PURPOSES OF SECTION 351?

As demonstrated above, the broad definitions of property expressed by the courts in such rulings as *DuPont, Stafford,* and *Hempt Bros.* obligate the Service to apply equally broad standards in analyzing the specific question of what forms of know-how will qualify as property under section 351. However, to focus exclusively on the property question is to ignore the equally important issue of what constitutes a qualifying "transfer" under the statute.[200] "Transfer" poses the question of what rights the transferor may retain in the property, yet still have the conveyance of the property deemed a transfer within the nonrecognition rules of section 351. One might expect that the lenient definition of property, particularly as analyzed in *DuPont,* would generate equally permissive standards regarding the kinds of transactions that will qualify as "transfers." Nonetheless, the Service has characteristically attempted to limit "transfer" to its strictest, most limited meaning. Relying almost exclusively on the judicial developments in the area of patent transfers for purposes of capital gains treatment under sections 1221, 1222, and especially

[200] *See* note 1 and accompanying text *supra.* Both the words "transfer" and "exchange" appear in section 351; however, the operative word is "transfer." Discussions have emphasized that for purposes of section 351 bona fide "sales" do not qualify as "transfers . . . in exchange". *See, e.g.,* Stanley, Inc. v. Schuster, 295 F. Supp. 812, 815 (S.D. Ohio 1969), *aff'd,* 421 F.2d 1360 (6th Cir.), *cert. denied,* 400 U.S. 822 (1970). Although the precise scope of the word "transfer" has been repeatedly addressed, many commentators have simply abided by the Service's restrictive rulings without questioning their validity. For a general discussion of the word "transfer" for purposes of know-how transfers under section 351, see BISCHEL, (no definition of what constitutes a transfer of all substantial rights) *supra* note 1, at ¶ 6.3; CALIFORNIA CONTINUING LEGAL EDUCATION, ATTORNEYS GUIDE TO TRADE SECRETS Ch. 6 (Brosnahan ed. 1971) (must transfer at least the right to prevent unauthorized disclosure); MILGRIM, *supra* note 7, at § 6.04 (discussion of the 1971 *DuPont* holding). *See also* Benjamin, *supra* note 44, at 200-01 (transfers of know-how under section 351 governed by § 1235); Burke, *supra* note 20, at 756-57 (Rev. Rul. 69-156 comports with legislative intent); Cohen, *supra* note 4, at 39-40 (Service's transfer requirements are highly questionable); Cooper, *supra* note 46, at 335-38 (discussion of the 1961 *DuPont* decision); Cooper, *supra* note 23, at 225-237 (discussion of transfer concept); Creed & Bangs, *supra* note 23, at 101-02, (discussion of all substantial rights test); Dunn, *supra* note 4, at 573-75 (discussion of the exclusivity element); Flyer & Buell, *supra* note 4, at 30 (discussion of the exchange requirement); Pugh, *Sales and Exchanges of Foreign Patents,* 20 N.Y.U. INST. FED. TAX 1305 (1962); Note, *supra* note 33, at 69 (Service's sale or exchange requirement is not supported by the Code).

1235, the Service has formulated tough guidelines as to how one may transfer know-how for purposes of section 351.[201] Briefly stated, only the unqualified transfer in perpetuity of the exclusive right to make, use, and sell unpatented but secret products

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[201] I.R.C. § 1235 states: "A transfer (other than by gift, inheritance, or devise . . . of all substantial rights to a patent . . . shall be considered the sale or exchange of a capital asset . . . ." A strong argument may be made that it is only because of the presence of the "all substantial rights" language of section 1235 and the characterization of this provision as one of the capital gains provisions that limitation on the word "transfer" arises. Section 351 contains neither of these limitations. Nevertheless, the Service has been extremely successful in arguing that know-how should be treated similarly to the § 1235 treatment of patents. *See* PPG Indus., Inc., 55 T.C. 928, 1012 (1970); Edward W. Reid, 50 T.C. 33, 40-41 (1968); Pickren v. United States, 378 F.2d 595, 599 (5th Cir. 1967); Commercial Solvents Corp., 42 T.C. 455, 467-69 (1964); Kimble Glass Co., 9 T.C. 183, 190-91 (1947); E.I. DuPont de Nemours & Co. v. United States, 296 F. Supp. 823, 833-34 (D. Del. 1969), *modified*, 432 F.2d 1052 (3d Cir. 1970); Stalker Corp. v. United States, 209 F. Supp. 30, 33 (E.D. Mich. 1962).

An extensive body of law has developed regarding the elements necessary for a patent transfer to qualify for capital gains treatment under section 1235. The debate has raged primarily around the meaning of two phrases, "transfer" and "all substantial rights." For a discussion of the development that only "sales" and not mere "licenses" are required to qualify for section 1235 treatment, see Waterman v. MacKenzie, 138 U.S. 252, 255-58 (1890) (transfer must amount to an assignment not a mere license); E.I. DuPont de Nemours & Co. v. United States, 432 F.2d 1052, 1053-57 (3d Cir. 1970) (transfer of anything less than all substantial rights is a mere license); Redler Conveyor Co. v. Comm'r, 303 F.2d 567, 568-69 (1st Cir. 1962) (citing the *Waterman* test); Carroll Pressure Roller Corp., 28 T.C. 1288 (1957); Halsey W. Taylor, 16 T.C. 376, 381-84 (1951) (transfer of entire interest constitutes a sale not a mere license); American Chem. Paint Co. v. Smith, 131 F. Supp. 734, 737-39 (E.D. Pa. 1955) (preservation of substantial limitations by transferor deemed this is a mere license); Thompson v. Johnson, 50-2 U.S. Tax. Cas., ¶ 9428, 13127-30 (S.D.N.Y. 1950) (citing the *Waterman* test). For a discussion of the "all substantial rights" test, see William W. Taylor, 29 T.C.M. (CCH) 1488, 1492-96 (1970) (must transfer the exclusive right to manufacture, use and sell); Jacques R. Milberg, 52 T.C. 315, 317-20 (1969) (mere license because transferor retained use after license terminated); Allied Chem. Corp. v. United States, 370 F.2d 697, 699-700 (2d Cir. 1967) (enough control retained by transferor to preclude transfer from being a sale); Young v. Comm'r, 269 F.2d 89, 91-94 (2d Cir. 1959) (right to terminate at will destroyed by sale treatment); Buckley v. Frank, 57-1 U.S. Tax Cas. ¶ 9525, 57055-61 (W.D. Wash. 1957). For a detailed discussion of the overall developments in the field of section 1235 transfers of patents see Campbell, *supra* note 21, at 32-42; Cooper, *supra* note 46, at 334-38; Cooper, *supra* note 23, at 213-37; Morreale, *Patents, Know-How and Trademarks: A Tax Overview*, 29 TAX LAW. 553 (1976); Pugh, *supra* note 200; Ramunno, *U.S. Tax Aspects of International Licensing Agreements*, 5 DEN. J. INT'L L. & POL'Y 113 (1975).

The following rights have been held to be substantial: (1) right to terminate (Lynn Gregg, 18 T.C. 291, 302 (1952), *aff'd* 203 F.2d 954 (3d Cir. 1953)); (2) geographical limitations (Don Keuneman, 68 T.C. 609 (1977)); (3) terms for years (Treas. Reg. § 1.1235-2(b)(iii)); (4) field of use restrictions (David R. Blake, 67 T.C. 7, 13-16 (1976)). In contrast, retention of the following rights has been held to be insubstantial: (1) legal title as security (Treas. Reg. § 1.1235-2(b)(2)(i)); (2) provision for forfeiture for nonperformance (Treas. Reg. § 1.235-2(b)(2)(ii)); (3) oftentimes, the absolute right to prohibit sublicensing (Treas. Reg. § 1.1235-2(b)(3)(i)).

within all the territory of a country will be treated as the transfer of all substantial rights in the property in that country.[202]

The "all substantial rights" requirement carried over from patent transfer cases under the capital gains provision, section 1235, to know-how transfers under section 351(a) has been fleshed out by Regulation § 1.1235-2(b) which defines the phrase as *not* including a grant of rights (1) which is limited geographically within the country of issuance; (2) which is limited in duration by the terms of the agreement to a period less than the remaining life of the patent; (3) which grants rights to the grantee in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; and (4) which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant.[203] In recent years, the courts have upheld the validity of all four of these subsections with regard to patent transfers pursuant to section 1235.[204] In attempts to implement the statutory scheme of section 1235, as interpreted in the regulations promulgated thereunder, the courts, in *Fawick*

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[202] Rev. Rul. 1956, 64-1 C.B. 133, 135. The Service also stated in the ruling: "The unqualified transfer in perpetuity of the exclusive right to use a secret process or other similar secret information qualifying as property within all the territory of a country . . ." will be treated as a transfer of all substantial rights." *Id.* Rev. Rul. 64-56 was amplified in Rev. Rul. 564, 1971-2 C.B. 179 where the Service ruled that in order for all substantial rights in a trade secret to be transfered, the transferor must transfer to the transferee the use of the trade secret for its full life. For a general discussion of the Service's position see 70-20 TAX MANAGEMENT MEMORANDUM, *supra* note 66, at 6-15.

[203] Treas. Reg. § 1.1235-2(b) (1965). The present section 2(b) of the regulation was not adopted until 1965, one year after Rev. Rul. 56, 1964-1 C.B. 133. *See* T.D. 6852, 1965-2 C.B. 289.

[204] *See* Don Keuneman, 68 T.C. 609 (1977) (the Tax Court reversed its pro-taxpayer stance in Estate of George T. Klein, 61 T.C. 332 (1973), *rev'd,* 507 F.2d 617, 621 (7th Cir. 1974), *cert. denied,* 421 U.S. 991 (1975), and Vincent B. Rodgers, 51 T.C. 927 (1969), and held that pursuant to regulation § 1.1235-2(b), licensing agreements containing geographic limitations were not "sales and exchanges" of all substantial rights in a patent); David R. Blake, 67 T.C. 7, 13-16 (1976) (the Tax Court reversed its pro-taxpayer stance taken in Mros. v. Comm'r, 30 T.C.M. (CCH) 519 (1971), *rev'd,* 493 F.2d 813, 816 (9th Cir. 1974), and Fawick v. Comm'r, 52 T.C. 104 (1969), *rev'd,* 436 F.2d 655 (6th Cir. 1971) and held that based on regulation § 1.1235-2(b), licensing agreements containing field of use restrictions did not constitute "sales or exchanges" of all substantial rights in a patent); William W. Taylor, 29 T.C.M. (CCH) 1488, 1493-94 (1970) (transfer is not a sale where the rights to manufacture, use, and sell were not exclusive); PPG Indus., Inc., 55 T.C. 928, 1014 (1970) (transfers for a fixed term of years did not constitute the "sale or exchange" of all substantial rights in the technology).

v. Commissioner, a 1971 Sixth Circuit decision,[205] and *Mros. v. Commissioner*, a 1974 Ninth Circuit decision,[206] formulated a two-step test for section 1235 "transfers": What did the taxpayers actually give up, and what did the transferor retain?[207] In the recent decision, *Don Keuneman*,[208] the two-tier analysis of *Fawick* and *Mros*[209] was relied upon by the Tax Court in its denial of capital gains treatment to a licensing agreement containing a geographical limitation provision.[210]

The analogy by the Service from the traditional "sale or exchange" interpretation of the transfer language in section 1235 to the "transfer . . . in exchange" language of section 351(a), particularly with respect to transfers of secret information and know-how, has been almost complete. In Revenue Ruling 64-56, the Service ruled that a transfer will qualify under section 351 if the transferred rights extend to all of the territory of one or more countries and consist of all substantial rights therein, the transfer being clearly limited to such territory, notwithstanding the fact that rights are retained as to some other country's territory.[211]

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[205] 52 T.C. 104 (1969), *rev'd*, 436 F.2d 655 (6th Cir. 1971).

[206] 30 T.C.M. (CCH) 519 (1971), *rev'd*, 493 F.2d 813, 816 (9th Cir. 1974).

[207] *See Mros*, 493 F.2d at 816 (two-fold test—(1) what did the taxpayer actually give up, and (2) what did he retain after the transfer?); *Fawick*, 436 F.2d at 662 (two-pronged test—(1) what the holder has left after the transfer, and (2) what he relinquished to the transferee). Support for this two-pronged test in both cases was premised upon S. REP. No. 1622, 83d Cong., 2d Sess. 439-40, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4785, 5082-83. For a detailed discussion of *Mros, Fawick, Klein, Rodgers, Blake,* and Senate Report 1627, see Don Keuneman, 68 T.C. 609 (1977). *See also* Hagen, *Are Capital Gains Still Available Via Patent Fragmentation: A Current Analysis*, 43 J. TAX. 78, (1975); Rodgers, *Transfer of Patent Rights*, 61 A.B.A.J. 374 (1975).

[208] 68 T.C. 609 (1977).

[209] *See* note 204 *supra*.

[210] 68 T.C. at 612-19. The court noted that if a patent could be sliced into smaller segments, and the "all substantial rights" test satisfied merely by transferring all such rights with respect to the segment, capital gains treatment would be allowed despite the retention of valuable rights. *Id.* at 618. In contrast to *Keuneman*, in Vincent B. Rodgers, 51 T.C. 927, 930 (1969), the Tax Court limited the "substantial rights" test to merely the rights to "make, use, and sell" and rejected the Service's interpretation of section 1235 as found in Treas. Reg. § 1.1235-2(b).

[211] Rev. Rul. 56, 1964-1 C.B. 133, 135. *See also* notes 60-63, and 202 *supra*. *Compare Cohen, supra* note 20, at 40 (the Service's field of use restrictions are highly questionable in light of past judicial recognition of the validity of such provisions), *and* Note, *supra* note 22, at 54, (the Service's "sale or exchange" test is not supported by section 351 or the regulations), *with Duffy, supra* note 20, at 1290-92 (secret industrial know-how is capable of being sold for capital gains purposes to a purchaser who acquires the exclusive and perpetual right to use the know-how in a particular country and the right to prevent

Except for Revenue Ruling 64-56's response to a hypothetical problem, neither the courts nor the Service have had an opportunity to apply or interpret the ruling's restrictive field-of-use and geographic limitations to a licensing agreement of know-how in gross.[212]

The Service has also argued for the grafting of two other limitations upon section 351(a), namely, "exclusivity" and "in perpetuity."[213] Analogizing to its successes under section 1235, the Service in Revenue Ruling 64-56 emphasized that a transfer of exclusive rights is one element necessary to the finding that a transfer qualifies under section 351.[214] In the 1967 decision, *United States Mineral Products Co.*, the Service unsuccessfully raised the exclusivity issue with regard to the transfer of certain know-how[215] under the capital gains rules. Recognizing the inherent validity of the Service's argument as premised on the regulations under section 1235, the Tax Court examined the "licensing" agreement involved, and contrary to the Service's urging found

the seller and others from disclosing or using the know-how in that country). The degree of resemblance between Rev. Rul. 64-56 and the Duffy formulation are uncanny.

[212] The closest a court has come to discussing geographic limitations in a know-how license may be found in United States Mineral Prods. Co., 52 T.C. 177 (1969) where the court explicitly held: "By granting to CAFCAN the exclusive right within the territorial limits of Canada to use and to grant to others the right to use the formulas and the design . . ." a "sale" occurred. *Id.* at 198-99. The primary authority cited by the Service to support its position in Rev. Rul. 64-56 was Lanova Corp., 17 T.C. 1178 (1952). Although recognizing that the transfer of the exclusive right to use an invention in the United States and other North and South American countries constituted a tax-free transfer under § 112(b)(5) (the predecessor of section 351; *see* note 25 and accompanying text *supra*), the court's primary focus was on a totally different issue, the basis for such assets. *Id.* at 1179. At no point in the opinion did the court ever discuss geographical limitations in licensing agreements. Totally contrary to the Service's position in 1964, there was every indication that geographical limitations and field-of-use restrictions were permissible. *See, e.g.*, R.N. Crank, 135 F. Supp. 242, 253 (W.D. Pa. 1955) (patent rights may be limited geographically or to a particular industry and still qualify as a sale). Language of similar breadth may be found in William S. Rouverol, 42 T.C. 186, 192-94 (1964).

[213] Treas. Reg. § 1.1235-2(b). *See* notes 201-203 and accompanying text *supra*. *See* Puschelberg v. United States, 330 F.2d 56, 60 (6th Cir. 1964) (exclusivity is a prerequisite to capital gains treatment in a patent transfer). *See also* Young v. Comm'r, 269 F.2d 89, 91-94 (2d Cir. 1959) (right to terminate at will is the retention of a substantial right); Rev. Rul. 156, 1969-1 C.B. 101 where the Service emphasized the importance of the exclusivity element in the transfer of a patent under section 351.

[214] *See* notes 201-203 and 213 and accompanying text *supra*.

[215] 52 T.C. at 191. The Service phrased its argument somewhat differently, urging that the exclusivity issue went to whether or not the formulas even constituted property under I.R.C. §§ 1221 or 1231.

that the transferor actually had granted an exclusive right to the transferee within the territorial limits of Canada to use, and to grant to others the right to use, the technical information in question.[216] In *Taylor-Winfield Corp.*, the Service again raised the argument that certain transfers of technology constituted no more than an exclusive grant of rights for a term of years followed by a nonexclusive grant of rights thereafter in perpetuity.[217] Not faring as well as the transferor in *United States Mineral Products Co.*, the taxpayer was unable to convince the Tax Court that *Mineral Products* was controlling.[218] Despite the presence of exclusivity language in the license, the Tax Court found that the retention of a sublicensing veto power by the transferor rendered the licensing agreement no more than a terminable license of unpatented technology and therefore was not a sale or exchange for capital gains purposes.[219]

The Service's final and most successful basis for attack upon transfers of know-how under section 1235 "sales or exchanges" has been the "in perpetuity" requirement. Attempting to clarify the meaning of this requirement, in the analogous context of a section 351 transfer as discussed in Revenue Ruling 64-56, the Service, in Revenue Ruling 71-564, held that a transfer of know-how under section 351(a) will constitute a qualified transfer if the rights are granted for a period lasting at least until the secret becomes public knowledge and is no longer protectible under the transferee country's laws.[220] The case law has unanimously sup-

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216 *Id.* at 177-200. Reviewing the language of the CAFCAN agreement, *id.* at 188, the court concluded that an exclusive license had been granted with respect to the know-how. In contrast, the CAFCUS agreement although granting exclusive rights failed the "in perpetuity" test. *Id.* at 195. *See* notes 220-225 and accompanying text *infra*.

217 57 T.C. at 213.

218 The court distinguished Mineral Prods. Co., 52 T.C. 177 (1969) on the grounds that the rights to sublicense was granted to the transferee in that case. Unlike *Mineral Prods. Co.*, in *Taylor-Winfield Corp.*, the transferee was precluded from sublicensing without the transferor's consent. In addition, the transferee was to hold the information in total confidentiality and secrecy. 57 T.C. at 219.

219 Delving beneath the mere form of the agreement, namely an exclusive license in perpetuity, the court found the transaction to constitute no more than a terminable license of unpatented technology. *Id.* For similar treatment of the issue of exclusivity of the right to prevent unauthorized disclosures by the transferees, see Edward W. Reid, 50 T.C. 33 (1968); Commercial Solvents Corp., 42 T.C. 455, 469 (1964); E.I. DuPont de Nemours & Co. v. United States, 288 F.2d 904, 912 (Ct. Cl. 1961); Stalker Corp. v. United States, 209 F. Supp. 30 (E.D. Mich. 1962).

220 Rev. Rul. 564, 1971-2 C.B. 179. More succinctly stated, the transfer must be for the life of the secret information.

ported this position with respect to the capital gains "sale or exchange" rules. In *Bell Intercontinental Corp. v. United States, PPG Industries, Inc.*,[222] and *Taylor-Winfield Corp.*,[223] grants for terms of years were denied capital asset status for failing the "in perpetuity" test.[224]

Amplifying its position in Revenue Ruling 64-56, the Service restated its position in another section 351 ruling:

> Secret information is sufficiently akin to patents to warrant the application, by analogy, of some of the principles of law relating to the *transfer* of patent rights. . . . The grant of patent rights . . . will constitute a transfer of property within . . . section 351 . . . only if the grant of these rights . . . would constitute a sale or exchange of property rather than a license for purposes of determining the character of gain or loss.
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> In order for a grant of patent rights to constitute a sale or exchange, the grant must consist of all substantial rights to a patent. . . . Likewise, in order for all substantial rights in a trade secret to be transferred, the transferor must transfer to the transferee the use of the trade secret for its full life . . . .[225]

Unfortunately the Service has totally ignored the policy and statutory construction grounds for distinguishing the meaning of the word "transfer" in section 1235 from its meaning in section 351, focusing instead upon the alleged sufficiency of kinship between secret information and patents. Revenue Ruling 71-564 is an excellent example of the confusion generated in this area by the Service's failure to distinguish the transfer issue from the property issue.

The major breakthrough for the taxpayer occurred in two decisions in 1973 and 1974. First, in the 1973 decision *E.I. DuPont de Nemours and Co. v. United States*, the Court of Claims was presented with the issue of whether a nonexclusive license of a patent constituted a qualifying "transfer" of property under sec-

[221] 381 F.2d 1004, 1020-21, 1022-23 (Ct. Cl. 1967) (the right to terminate without notice, by either side, at the end of the first ten years of the agreement, constitutes the retention of a substantial right in the information under sections 1221 and 1222).

[222] 55 T.C. 928, 1013-15 (1970) (transfer for a term of years is not the sale of all substantial rights in the information under section 1221).

[223] 57 T.C. 205, 214-20 (1971) (the right to terminate at the end of ten years constitutes the retention of a substantial right in the information for purposes of section 1235).

[224] *See also* Pickren v. United States, 249 F. Supp. 560 (M.D. Fla. 1965), *aff'd*, 378 F.2d 595 (5th Cir. 1967) (twenty-five year transfer was not a transfer of all substantial rights in certain formulas).

[225] Rev. Rul. 564, 1971-2 C.B. 179, 180. *See also* note 202 *supra*.

tion 351.[226] Recognizing that the Service's position rested entirely upon the case law and regulations under section 1235,[227] and contrasting totally contradictory purposes expressed in the legislative history of the two statutory provisions,[228] the Court of Claims stated: "In other words, the capital gains concept of a 'sale and exchange' is simply irrelevant to section 351, which has a quite different purpose and an independent postulate."[229] The court, comparing the purposes of the two statutes, observed that the core of section 351 was continuity of interest and continuity of control, while to the contrary, section 1235 treatment was triggered only by the complete divestiture of any interest in the patent transferred.[230] Aptly, the court remarked: "It would be odd to hold that a transfer had to look most like a complete disposition in order to avoid being treated for tax purposes as a complete disposition."[231]

The total underpinnings of the Service's position having been eroded, the court found it only a small step to include a nonexclusive license of substantial value, commonly thought of in the commercial world as a positive business asset, within the definition of property for purposes of section 351.[232] In effect, therefore, the court focused primarily on the issue of whether a mutual exchange of valuable items had occurred.

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[226] 471 F.2d 1211, 1212-13 (Ct. Cl. 1973). For a detailed discussion of the court's "property" analysis see notes 34-38 and accompanying text *supra*.

[227] *Id.* at 1213. The Service relied heavily on the fact that original section 351 (§ 112(b)(5)) and the capital gains provisions both had their origins in closely related provisions of the Revenue Act of 1921. *Id.* at 1217. *Compare* ch. 136, § 202(c)(3), 42 Stat. 230 (1921) (current version at I.R.C. § 351) *with* ch. 136, § 206, 42 Stat. 232-33 (1921) (current version at I.R.C. §§ 1201-1254). The court quickly disposed of the Service's argument by noting that the great variance in purposes between section 351 and the capital gains provisions greatly outbalanced any elements of cognate origin or statutory juxtaposition. *Id.* at 1218.

[228] *Id.* at 1213-16. The court noted that the capital gains provisions use such language as "capital assets" and "sale/exchange", while section 351 is couched in terms of "property" and "transferred . . . in exchange." *Id.* at 1214. More importantly, the capitals gains provisions are concerned with total divestiture while the core of section 351 was "continuance-of-taxpayer-control." *Id.* at 1214-15. In effect section 351 was aimed at deferring tax until a true outside disposition was made. *Id.* at 1214. For a discussion of the legislative history behind section 351, see notes 25-31 and accompanying text *supra*. To ignore this distinction between section 351 and the capital gains provisions is to emasculate the 80% control requirement of section 351.

[229] *Id.* at 1217.

[230] *Id.* at 1214-18. *See also* note 225 *supra*.

[231] *Id.* at 1217.

[232] *Id.* at 1218. *See* notes 34-40 and accompanying text *supra*.

Barely a year later, in May of 1974, the Supreme Court sounded the death knell for the Service's section 1235-351 analogy. As discussed in part II of this article, the Supreme Court implicitly adopted the Restatement of Torts, section 757, definition of trade secret as a federal trade secret standard in *Kewanee Oil Co. v. Bicron Corp.*[233] In effect, the Restatement recognizes that any secret compilation of information may qualify as a protected interest as long as it gives the possessor of such information a competitive advantage over those who do not know it or use it.[234] Similar language had already been applied to the transfer of know-how in 1961, when foreshadowing *Kewanee,* the Court of Claims in *E.I. DuPont de Nemours & Co. v. United States* held: "In each case [transfers of patents and trade secrets] the transferee . . . gets more than mere information. Of greater importance, he obtains what he believes to be a competitive advantage, a means for commercial exploitation and reward."[235]

The importance of the *Kewanee* decision rests therefore in its implicit rejection of the two-step *Fawick-Mros*[236] test for determining what constitutes a transfer of "all substantial rights." As properly noted in *Kewanee,* the perspective from which a trade secret or know-how transfer must be viewed is from that of the transferee, not the transferor;[237] what the transferor has retained

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233 416 U.S. 470, 474 (1970). For a discussion of the specific impact of *Kewanee* in trade secret law, see notes 110-121 and accompanying text *supra.*

234 416 U.S. at 474. *See also* notes 110-193 and accompanying text *supra.*

235 288 F.2d 904, 911 (Ct. Cl. 1961).

236 *See notes* 207 and accompanying text *supra.*

237 The Restatement definition makes competitive advantage both an indicia of as well as an element of a trade secret. RESTATEMENT OF TORTS § 757 (1939), as cited in *Kewanee,* 416 U.S. at 474-75. In contrast, the value afforded the information received by the transferee is totally ignored under the *Mros-Fawick* two-step test. (493 F.2d at 816; 436 F.2d at 662). As noted in *DuPont,* 471 F.2d at 1215, running throughout all of the capital gains provisions is a requirement that the transferee fully and completely divest himself of any interest in the transferred asset. The Code determines that gain or loss is to be determined at the time of the transfer. Consequently, the only way to determine if a sale has occurred is to determine if the transferor has retained any interest that would indicate a transaction falling short of a sale. In contrast, the very purpose of section 351 is to avoid the complete divestiture of ownership of the information by the transferor. 471 F.2d at 1215. *See also* notes 26-28 and accompanying text *supra. See particularly,* S. REP. No. 265, 67th Cong. 1st Sess. 11 (1921), *reprinted in* 1939-1 C.B. (part 2) 188. As noted in the *DuPont* decision, to give meaning to the control element under section 351, yet insist upon a "sale or exchange" is to bring about "disparate results not rationally connected to the fundamental principle behind section 351." 471 F.2d at 1217. The nature of the *Kewanee* competitive-advantage test is perfectly suited for section 351. Once the

is irrelevant in a section 351 transfer, if the assets transferred to the transferee will result in a competitive advantage to him.

Once one shifts to a test of "commercial advantage" to the transferee, many of the Service's positions regarding qualifying "transfers" become less defensible. The transfer of a trade secret or know-how which confers a commercial advantage upon the transferee-possessor who operates in a particularly limited sphere of business is no less property or no less a qualified transfer simply because the transferee's business or market extends over a geographical area encompassing less than the geographic bounds of the transferee's country.[238] Similarly, commercial advantage transferred to a corporation in one particular field-of-use may be totally unaffected by the transferor's conveyance or retention of the right to convey identical rights to a different transferee in a totally distinct field-of-use.[239]

"perspective of the transferor" test is abandoned only one participant's vantage point remains, that of the transferee. This test was implicitly adopted in *DuPont*, 471 F.2d at 1219. The court noted that DuPont "handed over" something of value, received stock in exchange, there was no disposition to an outsider, and the transferee remained in control; in retrospect, the very form of transaction that section 351 was aimed at. *Id.* at 1219. Should the Service contend that such a broad approach would open the floodgates for tax evasion, I.R.C. §§ 482 and 367 remain as powerful protectors of the federal fisc. *Id.* at 1220.

[238] Clearly the Service, the courts, and the legal commentators have noted that section 1235 excludes licenses containing geographical limitations from the concept of sales of all substantial rights. *See, e.g.*, Don Kueneman, 68 T.C. 609 (1977); Estate of George T. Klein, 61 T.C. 332 (1973), *rev'd*, 507 F.2d 617, 621 (7th Cir. 1974), *cert. denied*, 421 U.S. 991 (1975); Treas. Reg. § 1.1235-2(b) (1965); Rev. Rul. 56, 1964-1 C.B. 133; Burke, *supra* note 20, at 755-57; Duffy, *supra* note 20, at 1290-92. However, once the analogy to section 1235 is removed, the prohibition on geographical limitations seems less supportable. The most that can be said about an agreement containing a geographical limitation is that it is not a sale. However, to qualify for section 351 treatment this is exactly what the transferor must argue. The very structure of the language of section 1235 recognizes that a license containing a geographical limitation is a transfer; the statute reads: "A transfer . . . of property consisting of all substantial rights . . . shall be considered the sale or exchange." The Service has never argued that such tainted licenses are not transfers, but merely they are not sales. See the Tax Court decisions in Estate of George T. Klein, 61 T.C. 332 (1973), *rev'd*, 507 F.2d 617, 621 (7th Cir. 1974), *cert. denied*, 421 U.S. 991 (1975); Vincent B. Rodgers, 51 T.C. 927 (1969). There is no reason to read into the word "transfer" a requirement that the transfer be inclusive within the entire geographic bounds of a country.

[239] Recently, field-of-use limitations have also run into stiff opposition. *See* Blake v. Comm'r, 67 T.C. 7 (1976); Mros v. Comm'r, 30 T.C.M. (CCH) 519 (1971), *rev'd*, 493 F.2d 813 (9th Cir. 1974); Fawick v. Comm'r, 52 T.C. 104 (1969), *rev'd*, 436 F.2d 655 (6th Cir. 1971). *See also* the Revenue Ruling and articles discussed in note 200-01 *supra*. The same analysis used in note 238 *supra* is equally applicable, if not more so, to field-of-use restrictions. If a sale is the last form of transaction and the transferor means to effect under

As for the "exclusivity" and "in perpetuity" requirements espoused by the Service in the recent revenue rulings,[240] an analogy to field-of-use and geographic limitations analysis, as discussed above, may open to the taxpayer new avenues of attack upon the Service's position. By focusing on the broad meaning of the word "transfer" and by emphasizing the "competitive advantage" test of the Restatement and *Kewanee,*[241] the taxpayer may successfully argue that grants for less than the life of the trade secret or know-how, or retention by the transferor of the right to license others besides the transferee, may not appreciably lessen the advantage gained by the transferee. As discussed earlier, if the two-tier "what-has-been-retained" test of *Mros* and *Fawick*[242] is not applicable to a section 351 transfer, the transferor's retention of certain substantial rights should only preclude section 351 treatment if the transferee's right (competitive advantage) is materially impaired or diminished. Specific factual settings therefore must be examined to determine what effect such limitations may have upon the transferee. In addition, the Service always has sections 482 and 367 to fall back on in the event of a taxpayer's attempt to evade taxes through a section 351 transaction.[243]

In conclusion, the qualified "transfer" requirement of section 351 has often been confused with, or lost in, the maze of cases concerning the definition of the word "property" for purposes of section 351. The Service's guidelines for what constitutes a bona fide section 351 transfer have been even more befuddled as a result of its misplaced reliance upon an unfounded and insupportable section 1235-351 analogy. In light of the *DuPont* rejection of the analogy between sections 1235 and 351,[244] the taxpayer has been granted a second opportunity to fashion transfer guidelines more consistent with the purpose and rational underlying section 351.

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section 351, inclusion of a field-of-use restriction is one means recognized by the Service to avoid such a result. *See* Treas. Reg. § 1.1235-2(b) (1965).

[240] *See* the discussion of Rev. Rul. 64-56 and Rev. Rul. 71-564 at notes 202 and accompanying text *supra.*

[241] *See* the discussion of the Restatement definition of trade secret, as discussed in *Kewanee* at notes 110-193 and accompanying text *supra.*

[242] *See* notes 207-09 and accompanying text *supra.*

[243] I.R.C. §§ 367, 482. *See* the discussion in note 237 and accompanying text *supra.*

[244] *See* notes 226-32 and 237 and accompanying text *supra.*

In conclusion, the primary goal of this section has been to make the reader aware of the numerous weaknesses in the Service's already attenuated line of analyses regarding the word "transfer." Until the courts are presented with specific factual settings, it is difficult to speculate as to the potential erosion of the Service's position in the future.

CONCLUSION

The foregoing analysis has attempted to demonstrate that the standards adopted by the Service with respect to transfers of know-how under section 351 are substantially without legal foundation. The taxpayer seeking tax-free exchange treatment would be well-advised to structure his agreement so that information transferred is treated by the contracting parties as property. Common sense also demands that the taxpayer label his information in a manner consistent with the demanding property rules under Revenue Procedure 69-19, and the equally onerous "transfer" rules of Revenue Rulings 64-56 and 71-564. However, the taxpayer must also recognize that the Service's rules are distortions of the law. If the taxpayer is willing to litigate with the Service, he should attempt to stretch the concepts of property and transfer to their limits. Once in court, the taxpayer's chances of success should be far greater than those of the Service.