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PATENTING THE TAX CODE: MONOPOLIZING BASIC TAX STRATEGY

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In this paper I will discuss the new trend of patenting tax strategies and the ramifications therefrom. The paper will consist of five parts: an introduction where I generally go over the nature of the tax system in the United States; a discussion of business method patents and the consequences of patenting tax strategies; a case study of the first tax patent to be contested; an overview of the possible reconciliatory actions that the government is considering in addressing and possibly correcting the issue; and, finally, a conclusion where I argue that tax strategies probably are not patentable in the first place and even if they do slip through the system they should not be patented as a matter of public policy.

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I.
INTRODUCTION

Taxes are a necessary requirement for governments to raise revenue in order to serve their people. In the United States, for the government to be able to provide for the "Safety and Happiness" of the people as Thomas Jefferson wrote in the Declaration of Independence, a very large amount of money is needed in order to serve Americans.[2] The most recent data available shows that the Internal Revenue Service (IRS) collected about 1.1 trillion dollars from individual income taxes and a total nearing $2.3 trillion from all sources in 2005.[3] The difference is covered by corporate, estate, gift and other miscellaneous excise taxes.

When the government wants to raise a greater amount of funds than it normally expects to receive in a given year it must raise taxes, or create a new tax to create the desired revenue. New taxes are also often created to replace the lost revenues of repealed taxes or lowered taxes. Taxes are generally, and understandably, unpopular to most people. The trick that legislators play is by levying taxes on those that seem most able to pay them or in a manner that equates to a cost of doing or using the thing being taxed. Conversely, the game that the tax practitioners have traditionally played is that of planning around the tax law to minimize the liability for their clients.

The individual and corporate income tax scheme operates on what is known as a progressive rate system. As a person's income becomes greater, so does the percentage rate at which she must pay tax. These rates have varied greatly over time. In 1980 the top personal rate was 70%.[4] This was in stark contrast to the original income tax, provided by the ratification of the Sixteenth Amendment in 1913, that started at 1% for the first $20,000 and work up to a maximum rate of 7%.[5] The progressive system works under the impression that those most able to pay taxes, the rich, are obligated to pay at a higher rate than those with less income. Opponents of the current system say that a flat tax would be a more equitable method of taxation.[6] The flat tax would eliminate a progressive rate structure and have only one level of taxation. Typically this flat structure is also compounded with a much simplified tax code that

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2 THE DECLARATION OF INDEPENDENCE para. 2 (U.S. 1776).

3 IRS Data Book, FY 2005, Publication 55b. Also, Chief Financial Officer, Revenue Financial Management OS:CFO:R. *Available at* http://www.irs.gov/pub/irs-soi/05db07co.xls.

4 ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX 2 (2007).

5 *Id.* at 30-31.

6 *See Id.*

eliminates many deductions in favor of fairness and manageability.

However, with the tax code as complicated and convoluted as it currently is, virtually all wealthy individuals and corporations rely on a tax professional to help them wade through the mire that is tax law. Practitioners have the role of using the law to their clients' advantage so that they are subjected to the lowest possible amount of tax that is allowed under the law. While the government wants to bring in revenue, it also is not looking to have individuals of corporations pay more than they owe. The prudent practitioner is able to plan for the future and minimize tax liabilities.

II. TAX PLANNING AND PATENTS

An interesting new development, however, is that tax planers have started a movement towards patenting their tax advice. By doing so they can effectively sell plans of advice like it were a normal commodity or good. This differs greatly from the traditional roll that law and accounting firms have played of selling advice as a service. This recent trend raises a lot of questions on not only the legality of the practice, but also questions of professional responsibility and professional manageability abound.

The first question presented by the patenting of tax advice would undoubtedly be; 'Why?' Allen Kenney of Tax Analysts posses a short hypothetical of a situation that would bring forth the inspiration to patent tax advice in his article on the patent process.[7] The situation plays out that an associate at a firm has an epiphany about a new tax planning structure that could save his clients a large amount of money if implemented.[8] When he takes the plan to his supervising partner they think that if they were able to prevent other law firms from utilizing the same plan then they could corner the market and make a lot of money.[9] The story may be a hypothetical situation but it is probably a very accurate assessment on how the idea to patent advice first arose. Though the end result achieves the goals that patents exist for, the process of reaching the end goal is flawed.

The prolifically published U.S. Court of Appeals Judge for the Seventh Circuit, Richard A. Posner, writes that "[t]he standard rationale of patent law is that it is an efficient method of enabling the benefits of research and development to be internalized, thus promoting innovation and technological progress."[10] Patents are an economic reward for spending resources to develop new technologies and ideas. Is legal advice really

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[7] Allen Kenney, *The Birth of a Patent*, 2007 TNT 78-5, Apr. 23, 2007.

[8] *Id.*

[9] *Id.*

[10] WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF INTELLECTUAL PROPERTY LAW 294 (2003).

something that would constitute an innovation or idea that demanded the protection of patent law, however?

One possible argument that patenting advice, known as a business method patent, should be allowed is that if it does not get patent protection, the efforts that produced the method will be moved to a more technological arena that would warrant patent protection.[11] Though this argument may be properly founded on economic realities in the business world, it seems far less likely in the smaller, more specific legal world. Lawyers are not likely to stop being lawyers simply because their advice is not protected under patent law. It may be simply because the legal culture never thought of this as a right, or even a possibility, until very recently.

The Federal Circuit court affirmed the legality of a business method patent in State Street Bank & Trust Co. v. Signature Financial Group, Inc., 149 F.3d 1368 (Fed. Cir. 1998). The structure that was set up in the case was that of mutual funds pooling their assets in the form of a partnership in order to take advantage of economies of scale and the favorable tax attributes of being organized as a partnership.[12] Posner describes the tax planning strategy as an algorithm which permits its patentability.[13] The counter argument to the creation of this algorithm is that it is not deserving of legal protection because the costs of creating something that is no more than an idea is negligible.[14]

To receive a patent in the first place the invention must be useful, novel, non-obvious and fit into one of statutory classes of subject matter.[15] The idea that organizing two companies together as a partnership would result in some favorable tax treatment is not much of a novel idea and is rather obvious to anyone familiar with the tax law. This type of plan, in a generic, fit-any-situation layout, is not useful in the patent law sense.[16] Usefulness or utility is defined by Donald Chisum as the invention "perform[ing] some function of positive benefit to society" and by Posner as it having some economic viability; being something someone would be willing to buy.[17] Suggesting, in general, that two companies could pool their resources and achieve some tax benefits by organizing the pool as a partnership is not of much use to anyone and would not demand any sort of

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[11] *Id.* at 23 n.19.

[12] *Id.* at 328 n.81.

[13] *Id.*

[14] *Id.* at 329.

[15] DONALD S. CHISUM, CHISUM ON PATENTS §1.01 (2007). *See also* 35 U.S.C. §101, "Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefore..." *Id.*

[16] Chisum, *supra* note 14 at §1.03[5].

[17] *Id.* at §4.01; LANDES & POSNER, *supra* note 9, at 302.

fee to acquire such knowledge. If the specific situation in which it is used is what makes it novel and useful, then what is the need for patentability in the first place? If the plan's use in a specific circumstance is what makes it novel and useful, and subsequently patentable, then there is no need to patent it because the exact situation could not be duplicated anyhow. Any subsequent use of the plan could easily differ enough to avoid having to pay a royalty to the patent holder.

These arguments appear to be purely academic as the United States Patent and Trademark Office (USPTO) has been issuing more and more business method patents since the ruling in *Street Bank.* Prior to the ruling, only two patents had been issued for tax strategies.[18] Since the 1998 ruling, 51 strategies have been granted patents as business methods with at least 85 applications still pending.[19] A problem may lie in the confusion of different parts of the government encroaching upon the territory of each other. The director of the business methods technology center at USPTO, Wynn Coggins, said that "[r]ight now it's difficult to find folks that have an engineering background that qualifies them to be hired, but also have the finance or insurance or some type of other background to help us in those areas."[20] The USPTO is essentially making tax policy without having any tax knowledge. Though not illegal, the Treasury Department has expressed concern over the unequal treatment of different taxpayers in similar situations.[21] It seems intuitively wrong that one individual will not be allowed to follow the law in the same way as another because the later patented her interpretation of the tax code before anyone else did.

Lawyers by themselves are not businesses designed to produce goods. By patenting a strategy they are hoping to capitalize on the licensing fees that would correlate with other lawyers or practitioners utilizing the same method. This concept was addressed in the 2006 Supreme Court case of eBay Inc. v. MercExchange, L.L.C., 126 S. Ct. 1837. MercExchange held a business method patent for conducting online auctions and was trying to lease the rights to its use to both eBay and Half.com in a similar manner that it had with other online auction retailers.[22] In District Court, MercExchange won over the jury as they decided that eBay did in fact infringe on their patent and ordered damages but denied the injunctive relief motion.[23] Once the issue got to the Supreme Court they based their decision on denying injunctive relief based on a four factor test that has

[18] Dustin Stamper, *Tax Strategy Patents: A Problem Without A Solution?*, 2007 TNT 78-3, Apr. 23, 2007.

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] eBay v. MercExchange, L.L.C., 126 S. Ct. 1837, 1839 (2006) [hereinafter eBay].

[23] *Id.*

been established through prior patent cases.[24] The test the court used in eBay to determine if injunctive relief was warranted was as follows:

(1) that it has suffered an irreparable injury; (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) that, considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and (4) that the public interest would not be disserved by a permanent injunction.[25]

This test is interesting when applied to tax patents and taken in conjunction with Justice Kennedy's second concurring opinion in the case.

Kennedy writes that there is an emerging market of patent holders who acquire the patent for no other reason that collecting licensing fees as they themselves have no desire to capitalize on the patented invention directly.[26] When the threat of suing for infringement is simply a leverage tool to get others to pay a licensing fee then the economic structure of patents has fundamentally changed and the rules for relief for infringement should change in accordance.[27] Damages to a holding party could really be no more than court costs and enjoining the use of the patent serves no one's interests.[28]

This is a salient point when taken in the context of tax patents. It is possible that a person or company that could not even legally use the tax strategy could acquire a patent on it. Then, the only way in which the owner would derive and income from the patent would be to license the strategy or receive damages from winning infringement cases. From a purely economic stand point there is not a whole lot that is wrong with that scenario. Paying a licensing fee is simply a cost of doing business that would ultimately be passed on to the client. However, from a public policy stand point is that a practice that should be encouraged and allowed to continue?[29] A conventional argument would be that allowing the patents, it encourages more creative thought in developing new and original tax strategies that might be worth paying a licensing fee for in order to implement. However, as I discuss immediately below and in the Wealth Transfer case in Part III, the whole idea of a novel tax strategy is highly

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24 *Id. See also* Weinberger v. Romero-Barcelo, 456 U.S. 305, 311-313 (1982); Amoco Production Co. v. Gambell, 480 U.S. 531, 542 (1987) for more about the four factor test for injunctive relief.

25 eBay, *supra* note 21, at 1839.

26 *Id.* at 1842.

27 *Id.*

28 *Id.*

29 "That rule [of not patenting certain inventions like ideas] reflects 'both ... the enormous potential for rent seeking that would be created if property rights could be obtained in [those types of inventions] and ... the enormous transaction costs that would be imposed on would-be users.'" CHISUM, *supra* note 14, at §1.03 n. 73 (quoting LANDES & POSNER, *supra* note 9, at 305-6).

dubious.

Just trying to figure out if the tax strategy is novel or has been a practice that has been used before is just one of the problems for the USPTO.[30] Part of the problem is that much if not most tax advice is already protected to some degree and is not readily open to the public. The attorney/client privilege protects the advice from being disseminated to the public unless the client chooses to break it. Even in publicly traded companies that have to disclose financial statements to their investors, all of the information regarding specific transactions might not be known. Each step of the transaction may be thoroughly disclosed but it may be far from obvious how the whole transaction was structured and how each step was interwoven amongst the larger background.[31]

Realizing that the USPTO is inadequately trained to fully understand complex, tax-based financial transaction and unable to divest resources into forensic accounting to research past transactions, the Tax Section of the American Bar Association (ABA) has begun training programs geared towards patent examiners at the USPTO.[32] The first of such training sessions took place last January and worked to help examiners search for prior uses of estate planning techniques.[33] At the 2007 May meeting of the Tax Section of the ABA there is a program oriented the opposite way, towards the tax practitioner. The program is designed to educate tax and estate attorneys on how to research patents to ensure that their advice is not already patented by someone else. On the panel are two examiners from the USPTO.[34] Another option has been suggested that the USPTO be required to inform the IRS of any patent issued that may be a tax strategy or may be used as a tax strategy.[35] The IRS could then compile a database of patented tax strategies making research for practitioners and auditors far simpler and require less formal training on the intricacies of patent law and patent research.

However, there is a benefit to ignorance when it comes to patent infringement.[36] By not searching for patents when suggesting a strategy a

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30 35 U.S.C. §102(a) denies the issuance of a patent if the "invention was known or used by others in this country, or patented or described in a printed publication in this or a foreign country, before the invention thereof by the applicant for patent..."

31 David A. Weisbach, *Ten Truths About Tax Shelter*, 55 TAX L. REV. 215, 242.

32 *Id.*

33 *Id.*

34 American Bar Association Section of Taxation May Meeting, http://meetings.abanet.org/meeting/tax/MAY07/media/Teaching%20Tax%20Mini%20Program.pdf (last visited Apr. 25, 2007).

35 *Making Taxpayers Report Patented Tax Advice Is Bad Idea, Aicpa Rep Tells IRS*, 2007 TNT 55-3, Mar. 21, 2007.

36 Dustin Stamper, *USPTO Official Critical Of Bill To Prevent Patents On Tax Strategies*, 2007 TNT 94-1, May 15, 2007.

tax practitioner could be protected from the triple damages awarded for willful infringement.[37] Patent attorney with Buchanan Ingersoll & Rooney PC, Charles F. Wieland III, says that the "[c]urrent law does discourage patent searching."[38] This is all well and good if the practitioner were going to take the risk of recommending a strategy that is already patented even after knowing so. It may seem like a situation where the patent holder would have no way of even finding out that the patented strategy was ever implemented. As discussed in the next section, however, one such patent holder has sued to protect his patent.

III.
WEALTH TRANSFER GROUP AND PATENT NO. 6,567,790

Any relief that practitioners hoped to find in the courts over possibly infringing use of tax strategy patents was very recently squashed.[39] Wealth Transfer Group sued former Aetna President and CEO, John W. Rowe on January 6, 2006 in U.S. District Court for the District of Connecticut for infringement of their patent issued in May of 2003.[40] Rowe was trying to transfer money from himself to his family and minimize the gift tax that would have to be paid to the IRS.[41] In January of 2006 the firm sued Rowe, claiming that they owned a patent that covered the strategy used by Rowe.[42] Rowe placed about 28.5 million dollars worth of nonqualified stock options in two grantor retained annuity trusts (GRATs) that would pay him an annual income for a period of time and everything left would go to his family.[43] The issue that is scary to tax practitioners and their clients is that this plan was incredibly popular and a staple in estate planning.

Thomas P. Ochsenschlager, vice president of taxation for the American Institute of Certified Public Accountants, said that he would "bet you dollars to doughnuts it was done 100 times."[44] The technology boom in the mid to late 90s created a very large amount of wealth in this country that was tied up in stock options from the stock rich internet companies.[45]

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37 *Id.*

38 *Id.*

39 Stamper, *supra* note 17.

40 *Id.*; Wealth Transfer Group L.L.C. v. John W. Rowe, Docket No. 3:06-cv-00024-AWT (D. Conn.) *available at* 2006 TNT 138-11; U.S. Patent No. 6,567,790 (filed Dec. 1, 1999).

41 Steve Seidenberg, *Taxation Innovation; Patent Office receives criticism for issuing patents on tax strategies*, INSIDE COUNS., Dec., 2006, at 22.

42 *Id. See also* Wealth Transfer Group's website advertising their patent for funding GRATs with nonqualified stock options at http://www.wealth-transfer.com/options.html (last visited Apr. 27, 2007).

43 Seidenberg, *supra* note 40.

44 Stamper, *supra* note 17.

45 *Id.*

David Handler of the Chicago office of Kirkland & Ellis says that "[f]or anyone with an estate tax issue and more than one hundred thousand dollars in assets, [setting up a GRAT] is as run of the mill as they come."[46] It is clear that Wealth Transfer Group was not the first to use a GRAT and did not invent its use. Wealth Transfer Group first filed for their patent on December 1, 1999.[47] GRATs were well known far before Wealth Transfer Group filed for the patent. This being the case, it would warrant the non-issuance of the patent because of the first exception to the general rule of patentability.[48]

Congress purposefully amended the tax law to allow for the use of GRATs with the passage of the Omnibus Budget Reconciliation Act of 1990.[49] The applicable section of the Internal Revenue Code (the 'code') is 2702. Though the code and its corresponding treasury regulations did not explicitly provide for GRAT, the IRS issued guidance to taxpayers in 1992 regarding the qualification of GRATs under Section 2072.[50] The Private Letter ruling says that GRATs "are considered to be a reasonable interpretation of the statute" and are covered by 2702.[51]

Section 2702 establishes the rules for valuing the retained interest in the trust for gift tax purposes if the interest is transferred. This is an important step in establishing that the planning method of using the GRAT will stand up to the scrutiny of the IRS and allows for the ultimate reduction in gift taxes in the end. Rowe's plan was to receive payments from his GRAT for a fixed period and then for his retained interest to terminate.[52] By establishing that the retained interest has a set value, it can then be taxed if the interest is transferred. The trick is that the interest is never meant to transfer. When Rowe's interest term ends, he no longer has a retained interest in the trust. His tax attachment to the trust is effectively terminated. As long as Rowe is alive at the time the term of the trust end he does not have any "right to the income" of the trust which would force inclusion to his estate for estate tax purposes.[53] Establishing that the right, while possessed, does have value means that the initial transfer of the assets to the trust is subject only to the difference between the retained interest and the total interest. A properly constructed GRAT can make the retained interest almost equal to the total interest, thus avoiding gift tax on the initial

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46 Seidenberg, *supra* note 40.

47 U.S. Patent No. 6,567,790 (filed Dec. 1, 1999).

48 35 U.S.C. §102(a). *See also* CHISUM, *supra* note 14, at §1.03.

49 Pub. L. 101-508, §11602, 1991-1 C.B. 481, 524 (codified in the various sections of Chapter 14 of 26 U.S.C.); Seidenberg, *supra* note 40.

50 I.R.S. Priv. Ltr. Rul. 9245005 (July 31, 1992).

51 *Id.*

52 Seidenberg, *supra* note 40.

53 26 U.S.C. §2036(a)(1).

transfer.

Rowe needed the flexibility of the GRAT setup because of the nature of his assets that he contributed and the fact that he still wanted to get money from the assets. Stock options usually have a time limit for them to be exercised. He had to act immediately if he wanted to use them. Additionally, it was not necessary for him to transfer the options in a trust for the benefit of his children because he was still alive and able to take care of their needs. Finally, he still wanted to enjoy some of the income from the options. The GRAT was a perfect solution and perfectly legal from the standpoint of the IRS. Rowe could put the options in a trust, get paid an amount of interest from the trust for a number of years, end his interest and the trust's corpus could then pass to his children free from gift or estate tax. The key is the initial value of the retained interest being high in comparison to the total interest and the assets earning more than the Section 7520 interest rate assumptions. With his children named as the remainder beneficiaries, they would receive the growth of the assets free from gift tax to their father. Stock options for internet stock had a very high growth rate so a lot of money could be transferred to the children free from gift tax.

It is unfortunate for the legal community that the Wealth Transfer's case was never litigated to a conclusion, however.[54] District Court Judge Alvin W. Thompson approved a confidential settlement offer between the parties on April 12, 2007.[55] The allowance of the settlement may be seen as tacit approval of the validity of the patent as nearly 16 months worth of litigation should have been enough time to convince the judge to through out the case if he believed the patent to be erroneously awarded.

Another very odd aspect of the suit is that only Rowe was sued for infringement, the attorneys who advised him to use the stock-option-funded-GRAT were not named as defendants.[56] It seems that only one of the two groups, Rowe or the advisors, could be sued because one of them was actually the infringer. The other was a contributory infringer allowing for the infringer to infringe and is not subject to liability without knowledge of the infringement.[57] It is reasonable to assume that Rowe will take his losses out on his attorneys in a malpractice suit but is Rowe really the one that should have been sued here? There is a question of who is the one actually using the advice for purposes of infringement and possible licensing. Is it the client or is it the advisors? This is an extremely complicated question and a court decision involving its answer would have been very helpful to practitioners.

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54 Stamper, *supra* note 17.

55 *Id.*

56 Steve Seidenberg, *Crisis Pending*, ABA J., May, 2007.

57 Chisum, *supra* note 14, at §17.03[2].

IV.
ADDRESSING THE ISSUE

The structure of a GRAT is obviously very complex as is the reasoning behind it working the way it does.[58] There is a degree of familiarity required with the subject matter before it can be easily understood. The problem currently is that the patent office has not had any familiarity with trusts or the inner workings of the tax code.

"It's always the same story whenever there are new types of patents," says Stephen Schreiner, a patent attorney in the Washington, D.C., office of Hunton & Williams. "Eventually, the patent office develops a body of prior art, hires people to deal with this area and the system works well. . . . This has been the pattern with such things as biotech patents, software patents and business-method patents."[59]

The USPTO seemed somewhat ignorant to the possibilities of what patenting tax advice might bring too. The Commissioner of Patents was asked to testify before the U.S. Senate Finance Committee regarding tax advice patents in 2004 and stated that "there shall be no disparate treatment for different categories of inventions."[60] This statement is shows complete naiveté to his field of work. Design patents are only given 14 years of protection while plant patents are given 20.[61] Clearly, not all patents, let alone, technologies are created equal, despite the assertions of the Commissioner.

Nick Godici also seems to disagree with Schreiner about the system working well with the progression of time. He brags that "[t]o assist our examiners in finding pertinent prior art, we . . .have established 'Electronic Information Centers' which provide examiners with access to over 1000 non-patent literature data-bases, over one-third of which contain business and financial information."[62] Having a Web-MD account does not make someone a doctor; nor does a LexisNexis account make him a lawyer. As evidence of the accuracy and properness of the business method patents that have been issued, Godici cites that the rate of business method patents

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[58] See appendix for reproduction of the chart that diagramed a stock option GRAT from Wealth Transfer Group's patent application.

[59] Seidenberg, *supra* note 40.

[60] *Bridging the Tax Gap: Hearing Before the S. Comm. on Fin.*, 108th Cong., 194, 197 (2004) [hereinafter Godici tesitmony] (statement of Nick Godici, Comm'r of Patents for U.S. Department of Commerce), *available at* http://finance.senate.gov/hearings/95484.pdf.

[61] General Information Concerning Patents, http://www.uspto.gov/web/offices/pac/doc/general/index.html#design (last visited Apr. 26, 2007); *See also* Chisum, *supra* note 14, at §16.04 (discusses the duration for different patents).

[62] Godici testimony, *supra* note 59, at 198.

issued has been decreasing and the applicants have been complaining that the office's criteria have been too strict.[63] This is rather specious reasoning as it was shown above that the absolute number of patents is increasing and if Godici is testifying before congress then there must be a number of people who think they are being too liberal with their issuances.[64]

Godici's testimony before the Senate Finance Committee appeared to be more of a defense of the value of his work and a plea for more money.[65] He failed to address specific issues with tax patents and focused completely on the broader category of business method patents. It is not completely fair to say that a tax strategy is identical to a conventional business method in every respect that they need not be addressed separately. Tax strategies are unique because patenting them could "have a negative impact on [the taxpayers'] ability to comply with the tax law."[66]

Advocates argue that patents have protected other inventions that have to comply with laws and that tax advice is no different. "In theory, [a tax-strategy patent] isn't different from getting a patent on something that some other federal agency, such as the FDA, might have a say over," says Arti Rai, a patent law professor at Duke University School of Law.[67] Simply because there is a government agency that sets legal standards that must be followed does not mean that IRS is only a regulatory agency. A patent for a drug that passes the FDA's safety standards is not the same as a patented tax strategy. The patent on the drug does not patent the use of the law that sets the safety standards. It does not require the payment of a royalty by the next drug manufacturer because their drug passed the same test and failed to kill someone. Another posed example is a patent on an engine that must pass emissions laws.[68] This analogy would only work if the law required that something like a catalytic converter be used on all cars. Then someone went out and patented the very use of a catalytic converter. Patenting a tax strategy is not like the patenting of something that complies with a regulation like an emission approved engine or a safe drug. It is akin to patenting the regulation itself. The only way to comply with the law is to pay some else a royalty.

Despite the seeming insistence by the patent community that the patenting of tax advice is not a problem and perfectly legal under the patent law, there are others who are looking to change the law in order to protect

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[63] *Id.*

[64] Stamper, *supra* note 17.

[65] Godici testimony, *supra* note 59, at 201.

[66] Seidenberg, *supra* note 40 (quoting Mark Everson, commissioner of the IRS, in his July testimony to the House Subcommittee on Select Revenue Measures).

[67] *Id.* (Prof. Rai's profile is *available at* http://www.law.duke.edu/fac/rai/).

[68] *Id.*

the workability of the tax code.[69] Senator Carl Levin of Michigan has introduced the Stop Tax Haven Abuse Act (S. 681) with Senators Norm Coleman and Barack Obama co-sponsoring.[70] The act is a broad attempt to curb abusive tax shelters offering amendments to numerous sections of the code. Section 303 of the act also amends the patent laws under title 35 of the United States Code.[71] Section 102 of title 35 limits the availability of patents.[72] The amended act would include an exception for issuing a patent if "the invention is designed to minimize, avoid, defer, or otherwise affect the liability for Federal, State, local, or foreign tax."[73]

Even with such language in a bill that appears to be clear and precise, there is still the matter of the patent examiners being able to identify the application as a tax strategy whose goal is reduce tax liability. The heart of a patent application is the claim. Writing the claim has become more and more a work of art where the writer is trying to be as broad as possible in the claim as to afford her client the most protection.[74] Samuel Morse's patent application asked for "the use of the motive power of... electro-magnetism, however developed[,] for making or printing intelligible characters at any distance."[75] Very few people could have understood the principles of electro-magnetism in 1838 when Morse filed for his patent and the vagueness of his application could have granted him a monopoly on virtually all electronic communication had it been granted.[76] This is an important and illustrative example because only with the hindsight of about 170 years of technological innovation is it obvious that Morse's application was overly vague.

Without a high working knowledge of tax strategies, the patent office examiners cannot accurately make the same conclusions about tax patents.[77] In the tradition of vagueness in the claim many applicants "don't actually call their patent application a tax strategy in the title or really anywhere in it. So it can be kind of challenging for the examiners to find

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69 *Patenting Tax Advice Before the H. Comm. On Ways and Means*, 109th Cong. (2006) (statement of Dennis I. Belcher, Partner, McGuireWoods LLP, Richmond, Virginia).

70 S. 681, 110th Cong., §303 (2007), [hereinafter Abuse Act] *available at* 2007 TNT 35-28. *See also* Elizabeth A. Starrs et al., *Colorado Bar Opposes Patenting Of Tax Advice*, 2007 TNT 50-35, Mar. 5, 2007 (The Colorado Bar issued a letter to Sens. Levin, Coleman and Obama agreeing with the language of S. 681 to limit the patentability of tax strategies).

71 Abuse Act, *supra* note 69.

72 35 U.S.C. §102, Conditions for patentability; novelty and loss of right to patent.

73 Abuse Act, *supra* note 69.

74 Stamper, *supra* note 17.

75 LANDES & POSNER, *supra* note 9, at 323 (quoting O'Reilly v. Morse, 56 U.S. 67 (1853 U.S. LEXIS 273, 33) (1853)); *See also* CHISUM, *supra* note 14, at §1.03[1].

76 LANDES & POSNER, *supra* note 9, at 323.

77 Stamper, *supra* note 17.

that and put it in the right category."[78] If Senator Levin's bill passes and becomes the law, it is safe to assume that new patent claims would try their best to obfuscate the fact that the effect of the strategy is to avoid or minimize federal, state or international taxes. Examiners would need the ability to break down the proposed transaction and analyze the tax consequences to determine that it is "designed to" reduce taxes.[79] This unfortunately brings in the question of intent of the proposed transaction strategy. This is an area that some in the tax community has been working to clarify recently.

Intent is very difficult to prove in a court room and even more so on a tax return.[80] The courts and practitioners have created this idea known as the economic substance doctrine to aide in discerning the intention to avoid tax and some other intention that also has as a result the avoidance or reduction in tax.[81] Two recent cases that relied heavily on the concept of economic substance in the opinions are The Dow Chemical Co. v. United States, 435 F.3d 594 (6th Cir. 2006) and Coltec Industries, Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006). In both of the cases the courts said that the transactions failed to show any motive other than tax avoidance because they did not have economic substance.

The problem with the idea of economic substance is that there is no explicit definition for it. It is something that has been put together from cases and loosely described as having some risk of losing money.[82] The *Coltec* and *Dow Chemical* cases asked the Supreme Court to take up the economic substance doctrine and write the doctrine specifically into law.[83] Both of the cases were denied certiorari, however, on February 16th.[84] The Chief Counsel of the IRS, Donald Korb, believes that the refusal of the Supreme Court to pick up these cases on the basis of economic substance means that the court is satisfied with the current interpretation of the doctrine that does not need further explanation.[85] He also hopes that

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[78] *Id.* (quoting Wynn Coggins, *see supra* text accompanying note 19).

[79] Abuse Act, *supra* note 69.

[80] Weisbach, *supra* note 30, at 242.

[81] *See generally* Gregory v. Helvering, 293 U.S. 465 (1935) (The Supreme Court ruled that though the transaction complied with the tax code it was done only to avoid a dividend tax and, subsequently, disregarded the form on the transaction); *See also* Frank Lyon Co. v. United States, 435 U.S. 561 (1978) (The Supreme Court permitted the transaction because "a genuine multiple-party transaction with economic substance which [was] compelled or encouraged by business . . . realities . . . and [was] not shaped solely by tax-avoidance features . . . ." *Id.* at 583-84.).

[82] *See generally* Charles I. Kingson, *The Confussion Over Tax Ownership*, 93 TAX NOTES 409 (Oct. 15, 2001).

[83] Sheryl Stratton, *IRS, Tax Bar Urge Congress To Leave Economic Substance Alone,* 2007 TNT 36-2 (Feb. 21, 2007)

[84] *See* Dow's petition, Doc 2006-21019; Coltec's petition, Doc 2006-23232.

[85] Stratton, *supra* note 82.

Congress does not feel like they need to get involved and write a definition of the doctrine into the code as a definition can only damage the interpretation that he sees as currently free of problems.[86] Passage of S. 681 may force the codification of an economic substance doctrine to ensure the workability of the law from the standpoint of the USPTO. Asking examiners to determine intent of the proposed transaction using "a flexible judicial rule, what some are calling 'judicial overhang'"[87] is unreasonable to assure that the congressional intent of S. 681 is upheld.

The Texas Bar association has passed a resolution in support of amending 35 U.S.C. §287 to limit the enforceability of tax patents against those who may use a patented strategy.[88] Under the law as it is currently written:

[w]ith respect to a medical practitioner's performance of a medical activity that constitutes an infringement under section 271(a) or (b) of this title or (b)], the provisions of sections 281, 283, 284, and 285 of this title[referring to the remedies available to the injured party] shall not apply against the medical practitioner or against a related health care entity with respect to such medical activity.[89]

The Texas Bar wants to add an amendment that affords the same protection to tax practitioners as it does to medical practitioners under §287(c) of 35 U.S.C.[90] In a denial of certiorari to the Supreme Court,

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[86] *Id.*

[87] *Id.* (quoting Donald Korb).

[88] *Texas State Bar Passes Resolution On Patents Of Tax Planning Methods,* 2007 TNT 39-43 (Feb. 27, 2007) [hereinafter Texas Bar].

[89] 35 U.S.C. §287(c)(1) (2007), *amended by* 108 Stat. 4989 (1996).

[90] Texas Bar, *supra* note 87. Their proposed amendment is to add subsection (d) and would read as follows:

(d)

(1) With respect to a taxpayer's and/or tax practitioner's utilization of a tax planning method that constitutes an infringement under section 271(a) or (b) of this title, the provisions of sections 281, 283, 284, and 285 of this title shall not apply against the taxpayer, the tax practitioner, or any related professional organization with respect to such tax planning method.

(2) For the purposes of this subsection:

(A) the term "tax planning method" means a plan, strategy, technique or structure that is designed to or has, when implemented, the effect of reducing, minimizing or deferring a taxpayer's tax liability, but shall not include the use of tax preparation software or other mechanical tools used solely to perform or model mathematical calculations or prepare tax or information returns.

(B) the term "taxpayer" means an individual, entity or other person (as defined in Section 7701 of the Internal Revenue Code) that is subject to taxation directly, is required to prepare a tax return or information statement to enable one or more other persons to determine their tax liability, or is otherwise impacted by a tax law.

(C) the terms "tax," "tax laws," "tax liability," and "taxation" mean, or refer to as the context may require, any Federal, State (as defined in subsection (c)(2)(G) above), county, city, municipality or other governmental levy, assessment or imposition, whether measured by

Justice Breyer wrote in the dissent to the denial that patenting medical procedures "may inhibit doctors from using their best medical judgment; they may force doctors to spend unnecessary time and energy to enter into license agreements; they may divert resources from the medical task of health care to the legal task of searching patent files for similar simple correlations."[91] This argument for tax practitioners simply trying to interpret the law and apply it effectively for their clients appears to be equally persuasive as the medical exception for the Texas Bar. They also realize the unique nature and role of the tax law and the job of the tax advisor. Taxes do not directly save lives as medical procedures but their influence in every facet of life is indisputable.

V.
CONCLUSION

The area of patenting tax strategies is very unique and presents many different questions that are not easily answered by analogizing conventional situations. As Justice Kennedy points out in his concurring *eBay* decision, there have been "rapid technological and legal developments in the patent system" and that "it should be recognized that district courts must determine whether past practice fits the circumstances of the cases before them."[92] Kennedy recognizes something that Godici was trying to down play is his Senate testimony.[93] Just because business method patents have been allowed in the past does not mean that they are applicable to the current environment.

If the patent office is unwilling to actively curb the issuance of tax strategy patents then tax practitioners will have to seriously alter the way that they have traditionally done business. Though one patent attorney is

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income, value or otherwise.
(D) the term "tax practitioner" means any natural person who provides advice and consultation to a taxpayer with respect to a tax planning method or who is acting under the direction of such person in connection with the development or utilization of a tax planning method.
(E) the term "related professional organization" means an entity with which a tax practitioner has a professional affiliation under which the tax practitioner may provide advice and consultation with respect to a tax planning method, including but not limited to a law firm, accounting firm, or a bank.
(F) the term "professional affiliation" shall mean an employment or contractual relationship or partnership or other ownership interest.
(3) This subsection shall not apply to any patent issued based on an application the earliest effective filing date of which is prior to ________, 2007.

91 Laboratory Corp. of Am. Holdings v. Metabolite Laboratories, 126 S. Ct. 2921, 2928 (2006) (dismissing writ of certiorari as improvidently granted).

92 eBay, *supra* note 21, at 1842-3.

93 Godici testimony, *supra* note 59 at 198.

arguing that ignorance is better than researching possible patents;[94] I find this a very perilous path especially after Wealth Transfer Group's suit. Instead, a heightened awareness of the structure of the transaction that they may be recommending to their client is needed to assure that they are not infringing upon a patent. Not only to protect themselves from suits, but to protect their clients like John Rowe.

This added expense to assure compliance with the patent laws seems excessive however.[95] At what point does the patenting of legal strategies go too far? Can someone patent a criminal defense of insanity due to depression? If that was the situation that the defendant was in, who is to say he cannot use the defense? If Rowe had no other assets other that his stock options to fund the GRAT, why should he not be able to use them without paying for the right? Granted, a criminal defense case may be somewhat more pertinent as it involves someone's life and not their money. But is the legal basis behind the two situations all that much different? From a public policy standpoint I do not believe that this is merely a cost of doing business issue as it more greatly impinges upon an individual's ability to comply with the law.

As Professor Tim Wu notes in his article "When Code Isn't Law," that there is an economic interest for people and companies to want to avoid paying taxes.[96] The issuance of patents in this area is affecting the amount of taxes people *legally* are required to pay. While it is required by law that a person pay their taxes, they are only required to pay what they owe. By issuing patents on tax strategies, the USPTO is altering the amount a person legally owes. Companies would be willing to pay for patented tax strategies if, in the end, they came out economically ahead.[97] The issue is that they should not be required to pay for the ability to assert their legal rights in this case. Realizing the nature of tax strategies as being tools of compliance with the tax code, the Texas Bar's proposal should be implemented.[98]

If Congress and the USPTO fail to amend the current patent process and continue to issue patents for tax strategies then, as proposed above, a database of tax specific patents provided by the USPTO and run by the IRS would be an extremely useful tool and indeed, even a necessary one, for tax practitioners. Even if Senator Levin's proposed bill passes the database would be important because the bill does not invalidate previously issued patents.[99] A firm court decision is needed on a tax patent issue so that both

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94 *See* Stamper, *supra* note 35 (citing Charles F. Wieland III).

95 LANDES & POSNER, *supra* note 9, at 305-6.

96 *See generally* Tim Wu, *When Code Isn't Law*, 89 VA. L. REV. 679 (June, 2003).

97 *Id.* at 698.

98 *See* Texas Bar, *supra* note 87.

99 Abuse Act, *supra* note 69, at §303(b).

communities know where they stand legally. Congress will probably be unwilling to make too bold of a move before an issue is fully litigated rather than just settled as in Rowe's case. Undoubtedly, there is still much more to come from this.

Appendix[100]

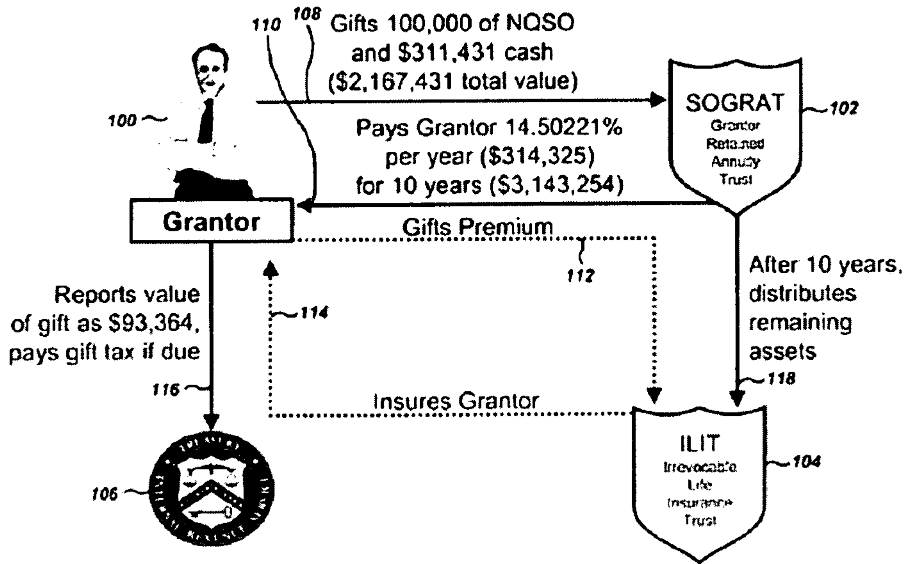

FIG 3

100 U.S. Patent No. 6,567,790 fig. 3 (filed Dec. 1, 1999).