BACKGROUND AND ISSUES RELATING TO THE PATENTING OF TAX ADVICE

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on July 13, 2006

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

July 12, 2006
JCX-31-06

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing for July 13, 2006, on issues relating to the patenting of tax advice. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the background and issues relating to the patenting of tax advice.

[1] This document may be cited as follows: Joint Committee on Taxation, *Background and Issues Relating to the Patenting of Tax Advice* (JCX-31-06), July 12, 2006.

I. OVERVIEW

Patents have increasingly been sought and issued for various tax-related claimed inventions, including strategies for reducing a taxpayer's taxes. Patented tax strategies that have attracted recent attention include methods that purport to reduce taxes in connection with wealth transfers such as estate and gift planning[2] as well as other situations.[3] This pamphlet provides background on patent law; describes some of the types of tax-related patents that have been issued; and presents some issues for consideration.

The general purpose of the patent law, grounded in the U.S. Constitution grant of Congressional power to enact such law, is to promote the progress of science and the useful arts.[4] To this end, the patent law encourages invention by granting an inventor an exclusive right to exclude others from using his or her invention or to seek money damages against infringers for a period of twenty years from the date of filing the patent application. These provisions enable inventors to reap the financial rewards of their inventive efforts. The patent law also requires public disclosure of patented inventions, thus giving notice of the scope of the inventor's proprietary rights and providing technical information to the public.

Inventors can obtain patents on processes, machines, manufactures, and compositions of matter that are useful, novel, and non-obvious, if other necessary requirements are also met.[5] In 1998, the Federal Circuit court held that methods of doing business could be patented. The case, *State Street Bank,*[6] involved a data processing system for a partnership structure of mutual funds that had advantageous tax consequences. The case is considered a key decision allowing the patenting of business methods of all types.[7] Since that time, other types of tax strategy-related

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[2] See for example, Deborah L. Jacobs, "Patent Pending", Bloomberg Wealth Manager, p. 41 (May, 2005); Rachel Emma Silverman, "Lawyers, Financial Advisers Are Getting Exclusive Rights to Estate-Planning Strategies," Wall Street Journal, p. D1(June 24, 2004); Wendy Davis, "Patenting Tax Strategies," Trusts and Estates p. 42 (March, 2004).

[3] See for example, Erik Larson, "Attorney Patents 'Tax Scheme' to Target Insurance Giant," IP Law Bulletin (Nov. 9, 2005); "Attorney's Patented 'Tax Shelter' Challenged Again," IP Law Bulletin (Nov. 28, 2005).

[4] Federal patent law is authorized under the Constitution of the United States, which grants Congress the power "To promote the Progress of Science and the useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries . . . ." U.S.Constitution, Art. I, Sec. 8, Cl. 8.

[5] Roger E. Schechter and John R. Thomas, *Principles of Patent Law* (West/Thomson, 2004) (hereafter "Schechter and Thomas, *op. cit.*"), p. 2; 35 U.S.C. secs. 101, 102, 103.

[6] *State Street Bank & Trust Company v. Signature Financial Group, Inc*, 149 F.3d 1368 (Fed. Cir. 1998); cert. denied 525 U.S. 1093 (1999).

[7] See Statement of Nicholas Godici, Commissioner for Patents, U.S. Patent and Trademark Office, before the Senate Committee on Finance Hearing on "Bridging the Tax Gap" (July 21, 2004).

patents have been issued, or applied for, in some cases involving tax strategies less related to computer or other mechanical data processing systems.

Inventors must apply to the United States Patent and Trademark Office (hereafter "USPTO" or "Patent Office"), which is empowered to grant patents if the requirements are met. A patent once granted enjoys a presumption of validity; however, accused infringers may assert that a patent is invalid or unenforceable on a number of grounds.[8] Some observers contend that the Patent Office lacks sufficient resources and examiners in new fields for which patents are sought, and that the public has inadequate opportunity to provide pertinent information prior to the grant of a patent. Thus, it is argued, the Patent Office may grant patents to claimed inventions that are not in fact novel or in cases where there is not adequate description of the claimed invention to alert other users that they may be within the scope of the patent claim. Legitimate other users thus might inappropriately be exposed to claims for damages, or prevented from using products, in cases where the patent-holder should not enjoy exclusive rights. It is claimed that such other users face unduly cumbersome litigation if they wish to challenge the patent-holder's claims. Other observers contend that these types of concerns have historically attended any emerging area of innovation and that the patent system has adapted to them and will continue to do so; therefore, there is no particular reason for concern. These issues are relevant to tax strategy patents, since the Patent Office has not historically been required to maintain significant tax expertise.

The patent law and process has been the subject of various legislative proposals[9] and hearings in the Congress. Both House and Senate Judiciary committees have conducted hearings during the 109th Congress on issues relating to the patent process.[10] Recent patent infringement

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8 Schechter and Thomas, *op. cit.* pp. 2-4.

9 Some patent reform proposals would expand the publication of patent applications, allow third parties to submit relevant information for inclusion in the record of patent applications, and set forth new procedures permitting third parties to oppose the grant of a patent. See, for example, the Patent Act of 2005 (H.R. 2795) and the Patents Depend on Quality Act of 2006 (H.R. 5096).

10 These hearings include (in reverse chronological order): (1) Patent Trolls: Fact or Fiction?: Oversight Hearing Before the House Subcommittee on Courts, the Internet, and Intellectual Property (June 15, 2006); (2) Perspectives on Patents: Post-Grant Review Procedures and Other Litigation Reform: Hearing before the Senate Subcommittee on Intellectual Property (May 23, 2006); (3) Patent Harmonization: Oversight Hearing Before the House Subcommittee on Courts, the Internet, and Intellectual Property (April 27, 2006); (4) Patent Quality Enhancement in the Information-Based Economy: Oversight Hearing Before the House Subcommittee on Courts, the Internet, and Intellectual Property (April 5, 2006); (5) The Amendment in the Nature of a Substitute to H.R. 2795, the "Patent Act of 2005": Legislative Hearing Before the House Subcommittee on Courts, the Internet, and Intellectual Property (September 15, 2005); (6) Perspectives on Patents: Harmonization and Other Matters: Hearing Before the Senate Subcommittee on Intellectual Property (July 26, 2005); (7) Patent Law Reform: Injunctions and Damages: Hearing Before the Senate Subcommittee on Intellectual Property (June 14, 2005); (8) Patent Act of 2005: Legislative Hearing on H.R. 2795 Before the House Subcommittee on Courts, the Internet, and Intellectual Property (June 9, 2005); (9) Committee Print Regarding Patent Quality Improvement (Part II): Oversight Hearing Before the House Subcommittee on Courts, the Internet, and Intellectual Property (April 28, 2005); (10) Perspectives on Patents: the Patent System

lawsuits involving popular products such as the "BlackBerry"[11] or the "1-Click"[12] method of ordering items on a website have attracted attention. A number of issues have been raised regarding patent law generally and related Patent Office procedures.[13]

Although patent policy is thus being examined across the board, some observers argue that tax strategy patents present policy issues unique to the special role of tax law and tax advice. They raise three basic areas of concern. First, might tax strategy patents lead to the marketing of aggressive tax shelters or otherwise mislead taxpayers about expected results. Second, might tax strategy patents encumber the ability of taxpayers and their advisors to use the tax law freely, interfering with the voluntary tax compliance system. Third, are there special definitional or practical problems in applying patent law concepts to tax practice and the filing of tax returns.

Some observers question whether the patent law purpose of encouraging invention needs to be applied to products designed to reduce taxes, especially through methods that are supposedly nonobvious to persons of ordinary skill in the tax law. They also ask whether patents might enhance the marketing of tax strategies that may not in fact achieve their advertised objectives if challenged by the Internal Revenue Service (IRS), and whether the IRS can readily be aware of the structures for which patents are sought, and their claimed results, so that it may consider whether to challenge such structures.

Other observers question whether exclusive proprietary rights should be granted at all for methods of compliance with the tax law, which is obligatory for all. Tax strategy patents might inappropriately burden tax practitioners and taxpayers with trying to determine whether structuring a transaction in a certain way or collecting data to report a transaction properly, has been patented or might be the subject of a pending application, before they can enter transactions, collect necessary data, or file tax returns. This concern is compounded since the existence of pending applications is not public knowledge for significant periods of time. Special statutory rules allow prior users of business method patents to defend against infringement claims by showing they had used the method before the patent application was

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Today and Tomorrow: Hearing Before the Senate Subcommittee on Intellectual Property (April 25, 2005); (11) Committee Print Regarding Patent Quality Improvement (Part I): Oversight Hearing Before the House Subcommittee on Courts, the Internet, and Intellectual Property (April 20, 2005). The Commissioner of Patents, U.S. Patent and Trademark Office, also testified before the Senate Finance Committee on July 21, 2004, as part of that Committee's hearings on "Bridging the Tax Gap."

[11] *NTP Inc. v. Research in Motion Ltd.,* 397 F. Supp. 785 (E.D. Va., 2005) (on remand from 418 F.3d 1282 (Fed. Cir. 2005).

[12] Preliminary injunction granted in *Amazon.com, Inc. v. Barnesandnoble.com., Inc.*, 73 F. Supp. 2d 1228 (W. D. Wash. 1999); vacated and remanded 239 F.3d 1343 (Fed. Cir. 2001).

[13] See for example, Peter Haapaniemi, "Have We Lost Our Way?", IP Business (spring/summer 2006) pp. 4-9; Robert P. Merges, "The Uninvited Guest: Patents on Wall Street," 88 Economic Review, Federal Reserve Bank of Atlanta, No 4 (Fourth Quarter 2003), pp 1-14; John R. Thomas, "Patents on Methods of Doing Business," CRS Report for Congress (June 1, 2000) at pp. 15-29; Wendy R. Schacht and John R. Thomas, "Patent Reform: Innovation Issues,"CRS Report for Congress (July 15, 2005).

filed. However, confidentiality obligations to clients might hinder the ability of a tax practitioner to produce the necessary proof.

In this connection, some raise questions about how patent protection applies as a practical matter in the case of a tax strategy patent. For example, if a tax strategy is patented, and if both tax advisors and taxpayers can be infringers, what are the practical implications, especially if one or the other is not aware of the existence of a patent or patent application? Does the infringement occur at the time a tax advisor discusses tax planning, at the time a tax planning structure is entered, or at the time the taxpayer's return is filed reporting a certain set of tax consequences? Such practical issues relate to the broader questions raised: whether giving tax advice, structuring transactions, or filing a tax return should ever be the subject of exclusive proprietary rights. The also require clear well understood answers, apart from the broader questions.

II. PATENT LAW BACKGROUND[14]

A. General Rights Granted by a Patent

Patent rights are granted and enforced according to conditions established by Federal statutory law.[15] A patent generally confers on its holder the right to prevent others from making, using, offering to sell, or selling within the United States, or importing into the United States, the patented item for twenty years from the date of filing the patent application. A patent can be assigned or licensed to others.[16]

A person who engages in any one of the five types of actions that are within the rights of of the patent holder has committed infringement,[17] though there could be situations in which the patent holder would not necessarily become aware of infringement or bring an infringement proceeding. A patent holder has the right to bring an action in civil court against those who infringe or induce others to infringe the rights granted by the patent. The patent enjoys a presumption of validity in the lawsuit, though an accused infringer may assert that the patent is invalid or unenforceable on a number of grounds.[18]

The patent holder may seek injunctive relief as well as money damages in an amount up to a reasonable royalty for the uses covered by the patent claim.[19] The money damages that may be claimed are "no less than a reasonable royalty." A patent holder may claim lost profits if he or she can show that, but for the infringement, he or she would have made the additional profits and the infringement is the proximate cause of the lost profits.[20] The question whether a patent holder must in some circumstances permit use of the invention by another and accept money damages has been the subject of litigation.[21]

The United States Court of Appeals for the Federal Circuit (the "Federal Circuit") hears appeals from the USPTO and also has nationwide jurisdiction over appeals from district court

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[14] The description of patent law contained in this pamphlet is drawn in large part from Schechter and Thomas, *op. cit.*

[15] The Patent Act of 1952, as amended, is the current statute. See Title 35 of the U.S. Code.

[16] 35 U.S.C. sec. 261.

[17] Schechter and Thomas, *op cit*. p. 275.

[18] 35 U.S.C. sec. 282.

[19] See 35 U.S.C. secs. 154, 281, and 283.

[20] Schechter and Thomas, *op. cit.* pp. 333-334.

[21] See for example, *Ebay Inc v. MercExchange L.L.C.*, 126 S. Ct. 1837 (2006).

patent decisions.[22] The United States Supreme Court has discretionary power to grant review through certiorari in patent cases.[23]

[22] 28 U.S.C. sec. 1295(a)(1) and (4).

[23] 28 U.S.C. sec. 1254.

B. Requirements for Patentability

In general

Qualified inventors may obtain patents on processes, machines, manufactures, and compositions of matter that are useful, novel, and nonobvious, if other necessary requirements are also met.[24] Under U.S. patent law only the "first inventor" is entitled to the patent. This requirement, like other requirements for patentability or challenging a patent, can involve difficult problems of proof.

In order to be entitled to a patent, an inventor must file a patent application with the USPTO that contains a specification that so completely describes the invention that a skilled artisan is enabled to practice it without undue experimentation. The application must also contain distinct, definite claims that set out the proprietary interest asserted by the inventor.[25]

Patentable subject matter

The Patent Act provides generally that "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 therefor, subject to the conditions and requirements of this title."[26] The categories "process, machine, manufacture, or composition of matter" are often generally referred to as patentable "subject matter." Courts have held that patentable subject matter does not include abstract ideas (including for example, mathematical algorithms), laws of nature, or natural phenomena, due to a concern for pre-emption if any person were entitled to claim an exclusive right to these.[27]

Some courts had also indicated that methods of doing business were not patentable subject matter, in some cases referring to pre-emption concerns, or to concerns that the methods were not novel or non-obvious.[28] However, in 1998 the Federal Circuit reversed a lower court and held that a business method was patentable subject matter as long as it involved a "process"

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[24] Schechter and Thomas, *op. cit.*, p. 2.

[25] Schechter and Thomas, *op.cit,* p. 2.

[26] 35 U.S.C. sec.101.

[27] See for example, USPTO Interim Guidelines for Examination of Patent Applications for Patent Subject Matter Eligibility, 1300 Off. Gaz. Pat. Office 142 (Nov. 22, 2005), which state:" The courts have also held that a claim may not preempt ideas, laws of nature, or natural phenomena. . . . Accordingly, one may not patent every 'substantial practical application' of an idea, law, of nature or natural phenomena because such a patent would "in practical effect be a patent on the [idea, law of nature, or natural phenomena] itself." [citing Gottshalk v. Benson, 409 U.S. 63 (1972)]".

[28] See for example, *State Street Bank and Trust Company v. Signature Financial Group, Inc,* 927 F. Supp. 502 (D. Mass, 1996) (and cases cited therein). This decision is the lower court decision that was reversed by the Federal Circuit Court in *State Street Bank, supra.*

or "machine" within the meaning of the patent law.[29] The case involved summary judgment on the legal question of whether business methods could be patented; thus the court never reached the questions of whether the claimed invention was in fact novel and non-obvious or whether the particular patent was overbroad.

Although there has been authority that patentable subject matter must involve a machine or other technological application such as a computer, recent Patent Office interim guidelines for examination of patentable subject matter allow the issuance of a patent without such a requirement.[30] The Patent Office has requested public comment on these guidelines.[31]

<u>Novelty</u>

The statutory requirement of novelty states that "A person shall be entitled to a patent unless − (a) 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. . . ."[32] Other separately stated statutory conditions can also defeat the novelty requirement, such as that the invention was "on sale" in the U.S. more than one year prior to the date of the application.[33] The prior knowledge or use that can preclude patentability is often referred to as "prior art."[34]

Although the literal statutory language might suggest that an invention would fail the novelty requirement as a result of prior art by the mere fact that the invention was "known or used by others" before the applicant, patent law places great weight on prior disclosure in making this determination. Thus, case law and commentators explain that the term "known" is interpreted as "publicly known" and the novelty requirement is satisfied if the invention "differs from existing references that disclose the state of the art, such as publications and other patents."[35] If there has not been prior disclosure (for example, if others have used the item but have not provided a description of the item in a retrievable form that can be accessed by others,

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[29] *State Street Bank, supra.* The *State Street Bank* case involved a computer application of a business method. The general topic of business methods patents is discussed in greater detail later in this pamphlet, under the heading "Business method patents," *infra.*

[30] Interim Guidelines for Examination of Patent Applications for Patent Subject Matter Eligibility, 1300 Off. Gaz. Pat. Office 142 (Nov. 22, 2005).

[31] See 70 Fed. Reg. 75451 (Dec. 20, 2005); 71 Fed. Reg. 34308 (June 14, 2006).

[32] 35 U.S.C. sec. 102 (a).

[33] 35 U.S.C. sec. 102(b).

[34] See for example, Wendy H. Schacht and John R. Thomas, "Patent Reform: Innovation Issues," CRS Report for Congress (July 15, 2005), pp. CRS-3 to CRS-5.

[35] 35 U.S.C.A. sec. 102 (1952 notes); Schechter and Thomas, *op. cit*, pp. 108-117.

or have purposely kept its nature a trade secret) then the fact of such prior use does not preclude patentability if the item passes the other requirements.

The type of "existing references" that can preclude patentability due to lack of novelty have been interpreted fairly broadly. For example, in one case, a doctoral thesis indexed and shelved in a library was considered sufficiently accessible to the public as a printed publication to constitute prior art."[36] Also, an orally presented paper at a forum open to all interested parties constituted an adequate "printed publication."[37] A publicly displayed document at an industry event can constitute a "printed publication" even if the duration of the display is only for a few days and the documents are not disseminated by copies or indexed in a database.[38] But a document disseminated internally within an organization with an expectation of confidentiality is not considered prior art.[39]

Nonobviousness

The requirement of nonobviousness is stated in the patent statute as a requirement that the invention be "beyond the ordinary abilities of a skilled artisan knowledgeable in the field."[40] Difficult factual inquiries are involved in this determination and commentators have noted that there is surprisingly little judicial authority regarding what should be considered "ordinary skill in the art."[41]

One common question is whether it would have been obvious to a skilled artisan in the field to combine elements of prior art to create a claimed invention. One concern is whether hindsight night improperly influence the approach to this question.

A significant test articulated by the Federal Circuit is whether there can be shown to have been a sufficient reason, suggestion, or motivation at the time of the claimed invention to combine the particular elements, and what specificity of proof is required. Some commentators have expressed the view that the Federal Circuit may be particularly rigorous in the specificity it requires, with the result that it may be difficult to for the USPTO to deny, or for others to

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[36] *In re Hall,* 781 F.2d 897 (Fed. Cir. 1986)(reissue application).

[37] *Massachusetts Institute of Technology v. AB Fortia*, 774 F.2d 1104, 1109 (Fed. Cir. 1985) (determination in proceeding attempting to enforce patent).

[38] *In re Klopfenstein,* 380 F. 3d 1345 (Fed. Cir. 2004) (proceeding to appeal denial of patent by USPTO. The slide presentation that precluded novelty was authored both by the appellants and another person. Various factors were considered in determining whether the presentation was sufficiently publicly accessible to preclude the issuance of the patent.)

[39] The forgoing examples appear in the USPTO Manual of Patent Examining Procedure, Patentability sec. 2128.01 (Level of Public Accountability Required).

[40] 35 U.S.C. sec. 103(a).

[41] See for example, Schechter and Thomas, *op. cit.*, pp. 158-159.

challenge, a claimed patent under the current standards.[42] The Supreme Court has recently granted certiori in a case involving the standards that should be applied.[43]

Utility

The term "useful" is not explicitly defined in the patent statute and the requirement has been phrased in a number of different ways. Some courts have noted that the utility standard is "not high."[44] One commonly used definition is that an invention is useful if it is "minimally operable towards some practical purpose."[45] The utility standard has been said to be met unless the claimed invention is "totally incapable of achieving a useful result" or "is incapable of serving any beneficial end."[46]

In some cases it has been argued that something that is against public policy or illegal fails to meet the utility standard and is thus unpatentable. For example, in *Juicy Whip Inc. v. Orange Bang Inc.,*[47] the district court held a patent invalid on the ground that the purpose of the invention was to increase sales by deception, that is, by making one product look like another. The Federal Circuit overruled the district court, finding that making one product look like another was in itself a specific benefit sufficient to satisfy the statutory requirement of utility. In making its decision, the court noted that the "utility" requirement is not a directive to the Patent and Trademark Office or the courts to serve as arbiters of deceptive trade practices: the task of protecting consumers is left to others.[48]

The *Juicy Whip* case reiterates the basic concept that a patent does not grant a right to use an invention, merely a right to exclude others from doing so. If regulatory or other legal requirements must be satisfied for an invention to be used, those need to be independently satisfied by the inventor or other users. For example, a patent might be granted for a drug, but it might be illegal to market or use the drug without FDA approval. If FDA approval is not granted, the inventor would be precluded from applying its patent not by patent law, but by the law that otherwise regulates the item in question.[49] Some commentators suggest that it might be possible

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[42] See, Schechter and Thomas, *op. cit.* at pp. 153-161.

[43] *Teleflex, Inc. v. KSR Intern. Co.,* 119 Fed. Appx. 282 (C.A. Fed. (Mich), 2005); cert. granted, -- S. Ct.--, 2006, WL 1725628 (U.S.).

[44] *Juicy Whip Inc. v. Orange Bang Inc.*, 51 USPQ2d 1700, 1702 (CA FC 1999).

[45] See *Brenner v. Manson,* 383 U.S. 519 (1966), cited in Schechter and Thomas, *op cit.*, p. 2.

[46] *Juicy Whip* at 1702.

[47] *Supra.*

[48] *Juicy Whip* at 1703.

[49] Schechter and Thomas, *op.cit.* p. 4.

for a concept of illegality to preclude grant of a patent, but that such limits are not imposed in application.[50]

As is the case with all inventions that might receive a patent, the fact that a tax strategy has been patented does not determine whether that strategy will in fact achieve its claimed objective. The IRS and the courts have the authority to interpret the tax laws. Thus, the IRS may challenge the validity of a taxpayer's position, even though the position is consistent with an issued patent. Although "utility" is a stated requirement for the grant of a patent, the fact that a patent examiner may have concluded that a tax planning method has utility has no bearing on whether it in fact will succeed as a tax planning or other method.

First inventor

Unlike the laws of many other countries, U.S. patent law grants the right to a patent to the first person to invent an item, rather than the first person to file a patent application. A first inventor must both have conceived of the invention and reduced it to practice.[51] However, a first inventor can lose the right to obtain a patent for himself, if he has "abandoned, suppressed, or concealed"[52] his invention. Thus difficult questions of fact may arise regarding when a "first inventor" is entitled to claim the rights to a patent even though another person may have filed an earlier patent application.

The patent law allows a procedure called an "interference"[53] when a patent claim is filed that appears to overlap with another pending claim or with an unexpired, issued patent. Procedures allow the several claimants to offer evidence regarding which is the "first inventor." Some commentators have noted that these are complex procedures that have been relatively rare; and that it is possible that the expense of such cases may lead to their use only in the most commercially significant cases.[54]

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[50] *Ibid*, pp. 69-72.

[51] Diligence in attempting to reduce an invention to practice can also be taken into account, even if the claimant is not the first to reduce it to practice. 35 U.S.C. sec. 102(g).

[52] 35 U.S.C. 102(g).

[53] 35 U.S.C. 135.

[54] Schechter and Thomas, *op. cit.* p. 118.

C. Procedure to Obtain Patents

A patent can be obtained only by application to the USPTO. A patent examiner reviews the application to determine whether the requirements for patentability are met. Patent office guidelines indicate that when a patent application is filed, the burden is on the patent office to set forth a prima facie case of non-patentability.[55] Thus, for example, if the patent examiner is not aware of information indicating that the claimed invention is not novel or is obvious, the presumption would generally be to issue the patent.

The patent application must contain a specification that so completely describes the invention that a skilled artisan is enabled to practice it without undue experimentation and to show that the inventor was in possession of the claimed invention at the time of filing. The application must also contain distinct, definite claims that set out the proprietary interest asserted by the inventor.[56]

Once issued, a patent enjoys a presumption of validity, though it can be challenged in court or by certain other methods.[57] An administrative procedure for re-examination may be brought with the USPTO by any person after the issuance of a patent. The grounds for invalidity must constitute a patent or a printed publication.[58] Certain other grounds (such as that the claimed invention was sold previously) are not permitted, presumably in the interests of problems of proof in a proceeding intended to resolve validity disputes relatively quickly and short of techniques involved in litigation.[59]

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[55] See Interim Guidelines for Examination of Patent Applications for Patent Subject Matter Eligibility, 1300 Off. Gaz. Pat. Office 142 (Nov. 22, 2005).

[56] Schechter and Thomas, *op. cit.* p. 2.

[57] Schechter and Thomas, *op. cit.* pp. 252-257.

[58] 35 U.S.C. secs. 301, 302.

[59] Schechter and Thomas, *op. cit.* pp. 252-257.

D. Time and Method of Public Notice of Patent Applications and Patents

A patent application generally does not become public until 18 months after the application is filed. If an applicant will not be filing for protection outside the United Sates, the applicant can opt out of the 18-month public notice and prevent the patent from becoming public knowledge until is it granted. Years may elapse between the time an application is filed and the time a patent is granted.

The patent office categorizes the application or issued patent according to subject matter. For example, there is a category for business method patents (705) and a more recent subcategory for tax patents (36T).[60] The categorization may assist persons who are attempting to search for publicly available patents or patent applications covering certain types of subject matter. It is not clear how difficult it is the public to search for patents or patent applications of a specified type, due to the various wording that is possible for applications and for issued patents.[61]

During the time that the patent application is pending and has not become public, the public may have little ability to provide information to the patent examiner regarding prior art that could bear on novelty or non-obviousness. Although many relatively informal types of "publication" have been held to preclude novelty, as cited in the USPTO manual and discussed above, it is not clear how readily the patent examiner may be able to discover the existence of such publications without outside input.[62] Such input might occur in the course of a reexamination proceeding, however.

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[60] See http://www.uspto.gov/patft/class705_sub36t.html

[61] As one possible example, the patent involved in the *State Street Bank* case is not in the 705/36T list for tax-related patents, but appears under a separate business method classification (36R).

[62] See discussion above under the heading "Novelty". At least some of the proceedings in which the existence of such publications came to light were either challenges to an already issued patent or a "reissue application" proceeding that involves public notice (for discussion of reissue proceedings brought by a patent holder to correct a defect in a previously issued patent or expand the patent claims, and the opportunity for public comment, see, Schechter and Thomas, *op. cit.* at 246). See for example, *Massachusetts Institute of Technology v. AB Fortia, supra; In re Hall, supra;* A third case involved a slide show that was found to defeat the novelty requirement and that was authored by another person and by the applicant. *In re Klopfenstein, supra.*

E. Special Statutory Defenses

First Inventor Defense Act

After the decision in *State Street Bank* that business methods could be patented, (described more fully below under the heading "Business Method Patents") there was concern that persons who had used business methods that perhaps had not been thought patentable, and who had not previously sought patent protection for such methods (in part, perhaps, since the law on patentability had been unclear), might be sued by someone who had obtained a business method patent.[63] The American Inventors Protection Act of 1999[64] included the First Inventor Defense Act,[65] which generally provides an infringement defense to an earlier inventor of a business method that was subsequently patented by another. In order to qualify, the defendant must have "actually reduced the subject matter to practice at least [one] year before the effective filing date of such patent, and commercially used the subject matter in the United States before the effective filing date of such patent."[66] This defense applies only to business method patents,[67] and the reduction to practice or use must have been made in good faith, without derivation from the patentee or persons in privity with the patentee.[68]

Physicians Immunity Statute

In 2000, following a controversial lawsuit in which one physician sued another for infringement of a patent on a cataract surgery technique and the condemnation of patents on medical procedures by the American Medical Association,[69] the Physicians Immunity Statute was enacted.[70]

Under this statute, a patent holder generally cannot obtain either damages or injunctive relief against a licensed medical practitioner or related health care facility with respect to the performance of a medical activity that constitutes an infringement of the patent. The statutory protection applies only for a medical procedure on the human body (or on an organ or cadaver, or a nonhuman animal used in medical research or instruction directly relating to the treatment of humans) which does not involve the use of a patented machine, patented matter, or a valid

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63 See Schechter and Thomas, *op. cit.*, 134-135.

64 Pub. L. No. 106-113.

65 Subtitle C of the American Inventors Protection Act, Codified at 35 U.S.C. sec. 273.

66 35 U.S.C. sec. 273(b)(1).

67 35 U.S.C. sec. 273(b)(3)(A).

68 35 U.S.C. sec. 273(b)(3)(B).

69 See, Schechter and Thomas, *op. cit.* pp. 38-40.

70 35 U.S.C. sec. 287(c).

biotechnology patent.[71] Therefore, while it is possible to obtain a patent on a medical procedure falling within the scope of the statute (such as a novel surgical technique), the patent holder generally will be unable to enforce such a patent against a licensed medical practitioner or related health care facility.

It has been observed that the provision is limited in application since it covers "medical methods" but expressly does not cover products, compositions of matter, and biotechnologies. In many cases a medical method may also involve a device of some kind. Thus, commentators have observed that if a doctor patents a new device (i.e. a machine or composition of matter) that is used in surgery, and also patents its manner of use as a "medical method," the doctor is not precluded from suing for infringement if another medical practitioner uses the patented device in surgery.[72]

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[71] 35 U.S.C. sec. 287(c)(2)(A).

[72] Schechter and Thomas, *op. cit.* pp. 39-40. Some commentators have criticized the statute and suggested alternative approaches to the concerns such as requiring a patent holder to license and recover money damages from an infringer. See for example, Steve Dirksen, "A Reconsideration of the Physicians' Immunity Statute", 2001 Duke L. & Tech. Rev. 0027 (August 6, 2001).

F. Business Method Patents[73]

The patenting of methods of doing business generally affects many areas beyond taxation. As one example, a recent case before the Board of Patent Appeals and Interferences of the USPTO involves a method of compensating a manager to provide incentives of various types.[74] A major case establishing the right to patent business methods involved tax as well as other business aspects, however.

State Street Bank case

In 1998, in the *State Street Bank,*[75] case noted previously, the Federal Circuit reversed a lower court decision and held that a method of doing business was patentable subject matter. The case involved a data processing system for implementing an investment structure of mutual funds as a set of "spokes" in a "hub" that is a partnership for tax purposes, and of performing the necessary calculations to allocate income and expense, compute daily share prices, and satisfy tax and accounting reporting obligations.

The Federal Circuit rejected a claim for summary judgment that business methods could not be patented. It also concluded that the invention could qualify as patentable subject matter as a useful machine. Prior to this decision, as the cases cited by the court indicate, whether a business method could be patented had arguably been uncertain. Some prior cases had indicated that such methods could not be patented.

The arguments raised in the case illustrate some of the issues that have surrounded the question of business method patents. The party challenging the patent, State Street Bank, first claimed the invention was similar to a mere mathematical algorithm that would not be patentable under case law that denies patentability to abstract ideas due to concerns about preemption of a field of knowledge. In a related argument, State Street Bank contended that the wording of the patent claimed was overbroad and that if the patent as claimed were valid, that would preclude any other business from setting up an investment structure as a partnership of funds, since such a form would always require performing the allocation calculations for which the patent protection was claimed. The Federal Circuit held that the invention for which patent protection was claimed was not a non-patentable mere mathematical algorithm or idea, but was a useful machine. The decision did not reach the question whether the patent claim was overbroad, saying that question was related to the requirements of novelty and nonobviousness, and not to patentable subject matter.

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[73] For general background on business method patents, see John R. Thomas, "Patents on Methods of Doing Business," CRS Report for Congress (June 1, 2000).

[74] *Ex Parte* Carl A. Lundgren, Appeal No. 2003-2088 (April 20, 2004).

[75] 149 F.3d 1368 (Fed. Cir. 1998), cert. denied 525 U.S. 1093 (1999). As noted previously, the U.S. Court of Appeals for the Federal Circuit (the Federal Circuit Court) has national jurisdiction over most patent appeals from the district courts. 28 U.S.C. sec. 1295(a)(1).

State Street Bank further argued that the invention was not patentable, even if it were otherwise patentable as a process or machine, because it was a method of doing business (the method of using a central partnership in which mutual funds or other investors are partners). The Federal Circuit rejected this argument and held that business methods were not *per se* non-patentable subject matter. The decision noted that other requirements of the patent law, including novelty, non-obviousness, and adequacy of disclosure and notice, would also have to be met to justify the grant of a patent. The decision did not address whether those requirements had in fact been met in the case before it, nor did it make any finding with respect to the question whether the patent claim before it was overbroad. The Federal Circuit expressed the view that many prior cases stating that business methods could not be patented could instead be read as implicitly involving situations where the courts had believed that other requirements for patentability, such as novelty or non-obviousness, had not been satisfied, or had implicitly involved claims for the patent of a pure idea without reduction to a particular useful process or machine.

***State Street Bank* patent**

The patent involved in the *State Street Bank* case[76] was originally claimed both in terms of a computer machine application and in terms of a method,[77] and includes tax elements. The Federal Circuit described the data processing system as facilitating a structure that offered "the advantageous combination of economies of scale in administering investments coupled with the tax advantages of a partnership."[78] The business structure pools the investment assets for its partner regulated investment companies (and other investor funds) in a single central partnership. The patent specification notes that a partnership is subject to different tax rules than a regulated investment company and provides advantages in the timing and measurement of tax realizations and in allocations, when compared to certain other structures (as one example, where one partner regulated investment company might instead invest in another).[79] The patent is for a data processing system that allows the performance of daily calculations of partnership interests and share prices, and year-end calculations for tax and accounting purposes under the structure.[80]

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[76] U.S. Patent No. 5,193,056 (Mar. 9, 1993).

[77] 149 F.3d 1368, 1371 (1998).

[78] 149 F.3d 1368, 1370 (1998).

[79] The patent observes that if one regulated investment company invested in another regulated investment company that had already realized gains during the year but before the investment occurred, the investing company would be taxed on receipt of the year end distribution, on gains that arose before it had invested. This would not occur if instead of investing in one another, each regulated investment company's investment assets were in a partnership and each was allocated its share of gains.

[80] The description in the patent ('056, *supra,* March 9, 1993; filed March 11, 1991), referring to the method of keeping track of book capital accounts, uses common terms also contained in the applicable tax rules for partnerships. The IRS later modified some of the tracking rules required for similar types of partnership structures. See for example, T.D. 8585, 1995-1 C.B. 120, 59 FR 66724-01 (Dec. 28. 1994); Rev. Proc. 2001-36, 2001-1 C.B. 1326 (relating to "qualified master feeder structures"), superseded by Rev. Proc. 2003-3, sec. 6.06, 2003-1 C.B. 113.

III. EXAMPLES OF TYPES OF PATENTED TAX STRATEGIES

Patents have been granted covering a wide variety of tax planning techniques. Some patents focus on the use of a computer as an essential element of the business method, while others rely primarily on the tax structure itself. Some patents relate to tax planning only indirectly.[81]

Until fairly recently, Patent Office procedures based on case law favored applications that were expressed in terms of computerization or other mechanical functions. In the tax context, this meant that patented tax techniques or strategies had to be performed using a computer. For this reason, it is not always clear whether a tax or other business method patent based on the computerization of a particular planning technique might also grant rights to the underlying strategy separate from the computer application.[82]

An example of a computer-based tax patent can be found in U.S. Patent No. 5,966,693, which involves a method for computerized administration of leveraged split dollar life insurance coverage. A split dollar life insurance arrangement describes a method of paying for insurance in an employment context, where premiums and proceeds are split between the employer and employee. In a typical leveraged split dollar plan, the employer borrows against the cash value of the life insurance policy to partly cover the cost of the insurance premiums. The abstract to the '693 patent describes the patented business method as follows:

> The computerized method includes storing parameters of insurance policies and loan agreements in a computer memory, over ranges of possible death benefits, cash values, loan principals, and incremental payments over a span of years. Employee factors are quantified and input to the computer processor, which is programmed to integrate the employee factors with the insurance and loan terms to select an integrated loan/insurance arrangement to schedule payments to meet maximum contributions and retirement and life expectancy expectations. The processor adjusts incremental payments for the employer and the employee to ensure sufficient collateral and to comply with tax regulations that are unfavorable to certain front-loaded payment schedules.

An example of a structure-based tax patent that does not rely primarily on the use of computers can be found in U.S. Patent No. 6,567,790, which describes an estate planning

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[81] As discussed previously, the grant of a patent does not limit the ability of the IRS to challenge a particular tax structure. Moreover, the general nature of the claims in some patent applications, and the lack of any specific facts, might make the claimed tax benefits difficult to evaluate in the abstract.

[82] See Interim Guidelines for Examination of Patent Applications for Patent Subject Matter Eligibility, 1300 Off. Gaz. Pat. Office 142 (Nov. 22, 2005). As noted previously, public comment has been requested on the interim guidelines. In a recent case the USPTO Board of Patent Appeals and Interferences concluded that the State Street Bank case and other authority led to the conclusion that a computer or other technological device was not required for patentable subject matter. *Ex Parte* Carl A. Lundgren, Appeal No. 2003-2088 (April 20, 2004), involving a method of compensating a manager that would provide certain types of incentives.

structure designed to minimize estate and gift tax liability through the use of a grantor retained annuity trust ("GRAT") funded with nonqualified stock options.[83] In a GRAT, the grantor creates an irrevocable trust and retains the right to receive, for a specified term, an annuity based on a specified sum or fixed percentage of the value of the assets transferred to the trust. GRATs are a commonly used estate and gift tax planning device. The rules governing the valuation of a retained interest in a GRAT are found in sections 2702(a)(2)(B) and 2702(b) of the Internal Revenue Code (the "Code"). In this patent, the "invention" is the use of nonqualified stock options to fund the GRAT. The '790 patent is currently the subject of litigation in federal court based on alleged infringement.[84]

Some business method patents involve tax planning only indirectly. For example, U.S. Patent No. 6,772,128 describes a business method for providing financial insurance to cover the costs of decommissioning a nuclear power plant. The business method contemplates the use of a decommissioning insurance policy and includes a method for receiving premiums from a trust, investing those premiums, and paying actual decommissioning expenses back to the trust in accordance with the insurance policy. The business method also describes a way to calculate premiums for the financial product. Although primarily an insurance product, the patent also claims that the business method provides tax efficiencies where funds are held in trusts that do not qualify for special tax treatment under section 468A of the Code (relating to the establishment of nuclear decommissioning reserve funds).

[83] While the patented invention is based primarily on the tax structure, the first claim in the patent is for a method "performed at least in part within a signal processing device." In addition, the patent application notes that in the "best mode embodiment of the . . . invention, the steps of the method are encoded in a software program which may be adapted for execution on any one of a variety of known type signal processing devices in any one of a number of different operating system protocols." U.S. Patent No. 6,567,790.

[84] See *Wealth Transfer Group v. Rowe,* No. 06CV00024 (D. Conn. filed Jan. 6, 2006).

IV. ISSUES RELATED TO PATENTING TAX STRATEGIES

In general

Government grants of patents for intellectual property involve the trade off of providing an incentive for the development of new knowledge and new products and services at the cost of creating a monopoly in the provision of the product or service so developed. The recent development of business method patents for tax strategies raises two distinct sets of concerns. Some observers express concern that the availability of patent protection may encourage, in a variety of ways, the development of aggressive tax shelter transactions, or of transactions that do not achieve the expected tax results. Separately, others note that the availability of patent protection for tax strategies could allow certain tax practitioners to seek and obtain patent protection for routine (and non-aggressive) tax planning, or even for certain methods of complying with the Code, effectively allowing such patent-holders to "capture" a property right in the Internal Revenue Code itself (as well as in Treasury Regulations and other administrative guidance) and extract economic rent from other tax practitioners (and taxpayers) for routine tax planning which is alleged to infringe such patents. In either case, it is argued that extending patent protection for tax strategies may be inconsistent with both tax policy and the policies underlying the patent system generally. Finally, tax patents raise certain practical questions independent of the underlying policy considerations.

Economics of patents

Technological innovation is an important component of economic growth. However, while an individual (or business) may acquire the necessary knowledge base and find it profitable to undertake some investments in research, he may not find it profitable to invest in research as much as he otherwise might because it is difficult to capture the full benefits from the research and prevent such benefits from accruing to other individuals and to society at large. In general, individuals and businesses acting in their own self-interest will not necessarily invest in education and research to the extent that would be consistent with the best interests of the overall economy. This result occurs because the benefits from such investments, such as scientific and technological advances, that are made at the expense of one individual or business could be cheaply copied by one's competitors.

Investment in the acquisition of knowledge is one of the areas where there is a consensus among economists that government intervention in the marketplace can improve overall economic efficiency. Numerous government policies seek to offset the underinvestment in knowledge that would otherwise occur if the full costs of such investments were borne by individuals privately. Among these policies are public provision of elementary and secondary education, public libraries, public support of State universities, public support of basic research at universities through direct grants, and public support of private research through the research and experimentation tax credit. Additionally, the patent system is intended to help encourage an economically efficient level of innovation.

Patents grant to their holder for a period of time the right to preclude others from using the item or idea that is the subject of the patent. This grants a monopoly to the holder of the patent. Economists have long recognized that monopolies are generally economically inefficient because the monopolist's profits are maximized by restricting output and setting a price above that of the cost of production.[85] This aspect of the patent system, alone, is unambiguously inefficient. However, economists also recognize, as discussed above, that without the ability to capture the economic returns from innovation, too little investment in innovation will result. Obtaining a patent provides a way to claim the economic benefits from one's innovations, and thus the ability to obtain a patent may lead to an increase in investments in innovation. Overall, the patent system is a tradeoff between the static economic losses of the grant of monopoly power and the dynamic efficiency gains from increased innovation stemming from the incentives created by the prospect of obtaining such monopoly power. The patent system leads to the early disclosure of information, which is economically beneficial to society as a whole, and which might otherwise be closely held as a trade secret. This disclosure of information helps to bring products to market from multiple vendors and provides the most up to date public knowledge base as a platform for future innovation.

Despite the theory, unambiguous economic evidence that patent systems increase innovation does not exist. A variety of reasons may be at play for why patents do not unambiguously increase innovation, including: (1) inventors have other means to protect their returns to innovation (e.g., trade secrets); (2) inventors may be motivated by other than strictly economic factors, such as professional reputation; and (3) patents themselves may harm follow-on innovation (due to need to obtain licensing fees to earlier inventors), which could be particularly harmful in rapidly evolving industries or in industries with complex technologies. In general, a patent system is thought to perform best for industries with very high development costs of new products (i.e., many costs to recoup before a successful invention is profitable) and easily duplicated products (i.e., free-riders could readily duplicate and sell your innovation), such as in the pharmaceutical or chemical industries.

Tax patents and tax avoidance

An initial concern is that tax shelter promoters might use patent protection as a means of circumventing the reportable transaction regulations. The reportable transaction regulations require a taxpayer that participates in a reportable transaction and that is required to file a tax return to attach to its return a disclosure statement in the form prescribed by the Secretary.[86]

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[85] This effect of monopoly occurs because when a monopolist lowers its price to increase sales, it loses revenue on all of the sales it was currently able to make at the higher price. Profit is thus maximized at a price well above the marginal cost of additional production (businesses in more competitive industries are considered to be "price-takers," with prices set by the aggregate market and only the amount that they produce in their direct control, and will maximize profits by producing as long as their marginal cost of production is less than the market-determined price). The economic inefficiency results under monopolies because the many potential users willing to pay an amount above the marginal cost of the product, but below the monopolist's profit maximizing price, are left unserved.

[86] Treas. Reg. sec. 1.6011-4(a). For this purpose, the term taxpayer includes any person, including an individual, trust, estate, partnership, association, company, or corporation. Sec. 7701(a)(1); Treas. Reg. sec. 1.6011-4(c)(1).

Under the regulations, a reportable transaction includes a listed transaction[87] and five other categories of transactions, including "confidential transactions," which are transactions offered to a taxpayer under conditions of confidentiality[88] and for which the taxpayer has paid an advisor a minimum fee.[89] A tax advisor who wishes to protect a "proprietary" tax structure from duplication by other competing tax advisors must, under present law and absent the availability of patent protection, weigh the cost of public disclosure (if the advisor does not insist on confidentiality) against the cost of having the transaction characterized as a reportable transaction and thus subject to heightened scrutiny (if the advisor insists on confidentiality, rendering the transaction a confidential transaction). Availability of patent protection offers a third approach, however: the tax advisor can obtain a business method patent on the structure (thereby providing the desired protection against unauthorized duplication by competing tax advisors) and then drop any requirement of confidentiality, thus avoiding treatment as a confidential transaction and eliminating any obligation of the taxpayer to specifically disclose to the IRS its participation in and the details of the transaction.

While some critics argue that this and related concerns militate against allowing patent protection for tax strategies altogether, others maintain that this initial concern can be effectively addressed in ways other than an outright prohibition on tax strategy patents. For instance, the IRS and Treasury could amend the reportable transaction regulations to include the application, grant, or use of a tax strategy patent (either of one's own patented strategy, or pursuant to a license from the patent-holder) as a reportable transaction, or could issue administrative guidance treating certain of these actions as listed transactions. Likewise, patent-holders might be required to provide the IRS with lists of those to whom the patented tax structure has been marketed. Further, to the extent the IRS concludes (on a case-by-case basis) that a particular patented tax strategy constitutes an abusive tax avoidance transaction, the IRS can issue guidance identifying it as a listed transaction.

Separate issues arise in connection with the mandatory public disclosure of issued patents. This mandatory public disclosure and its role in improving the dissemination of information is often highlighted as one of the principal benefits of the patent system.[90] With regard to tax strategy patents, even some who are concerned about patents on aggressive tax avoidance strategies nevertheless suggest that the information flow from the patenting of tax strategies may allow the Congress and the IRS to more quickly identify and address any abusive

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[87] A listed transaction is a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011 (relating to the filing of returns and statements), and identified by notice, regulation, or other form of published guidance as a listed transaction. Sec. 6707A(c)(2); Treas. Reg. sec. 1.6011-4(b)(2).

[88] A transaction is considered to be offered under conditions of confidentiality if the advisor places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies. Treas. Reg. sec. 1.6011-4(b)(3)(ii).

[89] Treas. Reg. sec. 1.6011-4(b).

[90] Schechter and Thomas, op. cit., pp. 9-12.

tax strategies, thus curtailing the availability of such strategies. According to this argument, patents for aggressive tax structures provide a useful window into the current "state-of-the-art" in tax shelter creation and promotion, and allow the IRS to focus its limited enforcement resources accordingly.[91] Under this view, these benefits might be enhanced by legislation providing the IRS with earlier access to tax patent applications; for instance, notwithstanding the general rule that patent applications are made public only 18 months after filing (or, at the election of the applicant, not made public until the patent is granted if the applicant is not filing for protection outside of the United States), the IRS might be provided, by statute, with access to all patent applications (or those determined by the Patent Office to have a tax component).

Another issue relates to the marketing of patented tax strategies to investors. The grant of a patent in no way constitutes government (i.e., IRS) approval of the purported tax treatment asserted by the patent-holder; indeed, the IRS is often unaware of an application for a tax strategy patent until after the patent is granted. While this fact is likely to be readily understood by large and sophisticated corporate taxpayers (many of whom employ a number of in-house and outside legal advisors well-versed in both intellectual property law and tax law), this critical point may not be appreciated by an individual without formal legal training and with limited direct interaction with the Federal government. It is argued that unscrupulous tax shelter promoters could prey on such unfamiliarity by falsely holding out a patent as evidence that an aggressive tax structure has been reviewed and approved by the government and that it thus "works" as advertised. A patented tax strategy also might fail to produce the anticipated tax results for a number of reasons other than an intentionally aggressive structure, including a mistake in understanding the tax law, or the application to particular facts in a way that changes the result. Some have suggested that requiring certain disclosure by advisors and promoters (e.g., a statement that the existence of a patent bears absolutely no significance to the merit of the asserted tax treatment) could resolve these concerns; however, others argue that such disclosure might have only a modest effect, particularly where the target audience consists of relatively less-legally-sophisticated individual investors who might easily dismiss any such required disclosure language as incomprehensible or irrelevant "fine-print."

One might be tempted to address this problem by requiring the IRS to analyze and opine on the legal merit of tax strategies on which patents are sought at the application stage, so that the issuance of a patent would indeed constitute evidence of IRS approval. However, it is likely that such an approach would be enormously burdensome and highly inefficient.[92] The IRS currently provides prospective guidance to specific taxpayers about specific transactions, primarily through the issuance of private letter rulings, which can generally be relied upon only by the taxpayer to whom it is addressed. Requiring the IRS to rule on the tax treatment of a hypothetical isolated fact-pattern set forth in a patent application, and then allowing the general

[91] However, others point out that publicly disclosed information is available not only to the IRS but to other taxpayers and tax advisors as well, and argue that expanding the scope of public knowledge in the field of tax planning may only exacerbate the problem of tax shelter activity.

[92] Furthermore, such an approach would arguably be inconsistent with patent policy and procedure generally (for instance, approval of a patent on a new drug is not conditioned on either its legality or government approval for medical use).

public to rely on approval of the patent as evidence of IRS sanction of the asserted tax result, could have negative effects on tax administration and procedure.

Finally, the primary economic rationale for a patent system − to promote innovation − is premised on the assumption that innovation is socially beneficial and should be encouraged. Innovation that, for example, makes compliance with tax laws easier is presumably beneficial. In the context of tax-strategy patents, however, some may argue that innovation is either not socially beneficial, or requires no special protection to encourage its undertaking, and thus a fundamental premise behind a patent system is missing.[93] Specifically, many would argue that no social gains from novel tax planning strategies exist as any gain to the user of the strategy is offset by losses to the Treasury, and therefore the resources devoted to producing and using such strategies represent a net loss to society. To the extent that this view of tax strategies is held, a patent system for tax strategies would only be socially desirable if it decreased the use of tax strategies. This is theoretically possible because, as noted above, a monopolist restricts "output," and this effect could outweigh the innovative effect that leads to the development of more tax strategies. Others would argue that, regardless of whether tax strategies are socially beneficial, there is no need for patent protection in order to encourage their development as they seem able to proliferate without such protection.

Tax patents and the private capture of public tax law

Independent of concerns about the consequences of allowing patents for aggressive tax avoidance strategies (i.e., tax shelters) or for novel tax structures in general, a separate set of concerns arises when considering patents on non-aggressive or even mundane tax strategies. The focus of these concerns is on the risk that patent-holders could effectively claim ownership of certain routine planning tools, or even of a method which constitutes the most efficient (or, in the extreme, the only) manner of complying with the requirements of the Internal Revenue Code and administrative guidance thereunder.[94] This concern is similar to those arising in areas other than tax law, generally involving the intersection of patent law with some other regulatory regime. For example, commentators have observed that government health and safety standards can sometimes only be met by using a patented product or method, and have considered the appropriate policy response to such situations.[95]

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[93] This is not to say that any and all tax planning is inappropriate or improper. As Judge Learned Hand famously opined, "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935). But acknowledging that tax planning may be legally and ethically permissible is hardly to say that it is socially desirable or might not otherwise be undertaken without the protection of exclusive proprietary rights.

[94] The grantor trust structure described in the example section of this pamphlet demonstrates the issues involved. In that case, patent protection was granted to a trust structure that many might view as routine based primarily on the type of assets (nonqualified stock options) used to fund the trust.

[95] See for example, Janice M. Mueller, *Patent Misuse Through the Capture of Industry Standards,* 17 Berkeley Tech. L. J. 623 (2002) (ultimately concluding that "when government mandates a

Some critics argue that granting a patent to a tax strategy under such circumstances is tantamount to granting the patent-holder an ownership right over the relevant provisions of the tax law (one or more sections of the Internal Revenue Code, for instance, or a Treasury Regulation) and allowing the patent-holder to collect economic rent from other taxpayers whose transactions or activities fall within the scope of such statutes or regulations; these critics view such a result as intolerable and contrary to the public interest, and argue that patent protection should therefore not be available for tax strategies. Even advocates of this position, however, caution that any exclusion from the scope of patent protection should be narrowly tailored, to avoid inadvertently prohibiting patents on, for example, proprietary software which a taxpayer could use to assist in managing financial information and in preparing its tax return.[96]

Others argue that concerns about the patenting of common and routine tax planning structures may be overstated, particularly in light of the statutory first inventor defense.[97] As tax strategy patents are arguably business method patents, the first inventor defense will apply to provide an infringement defense to any tax practitioner who "acting in good faith, actually reduced the subject matter to practice at least 1 year before the effective filing date of such patent, and commercially used the subject matter before the effective filing date of such patent."[98] However, while the first inventor defense protects a veteran tax practitioner with regard to long-standing tax planning structures, it will not protect a tax practitioner who develops a new tax structure based upon a change in the tax law against a patent-holder who filed a patent application on the same structure within a year or less of the tax law change that rendered the structure possible or desirable.[99]

Still others argue that the issuance of tax patents imposes additional onerous requirements on tax practitioners, who may now have a "due diligence" obligation to conduct a patent search before providing tax advice to a client, in order to assure themselves that they are not infringing

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technology standard . . . any entity holding patent rights in the subject matter of the standard should be required to license all users at reasonable commercial terms," and failing that "the government should consider the exercise of eminent domain over the patent").

[96] Protection for proprietary software under these circumstances would need to be distinguished from protection for business methods that are presented as involving the use of a computer to make necessary calculations.

[97] 35 U.S.C. sec. 273.

[98] 35 U.S.C. sec. 273(b)(1).

[99] The first inventor defense will also not protect a tax practitioner who is new to the field, even with regard to the implementation of long-standing tax planning structures which are subject to a patent. Similarly, if infringement consists not only of a tax advisor assisting a client to implement a patented structure, but also of the client's implementation, the first inventor defense will generally not protect the client taxpayer unless it had implemented the same structure more than one year prior to the patent filing date.

others' patents.[100] Conversely, granting patents for tax strategies may raise professional ethics issues for practitioners who seek and obtain patents, as well (and may raise issues under the relevant code of professional responsibility to which the practitioner is subject). One possible resolution of these issues would be analogous to the legislative response to similar issues among medical professionals: legislation could be enacted, modeled on the Physicians Immunity Statute,[101] which would provide attorneys, accountants, and other tax advisors with immunity from an infringement action arising in connection with the provision of tax advice.[102]

Some observers contend that many of these issues do not demonstrate an inherent problem with tax patents, but rather arise from the misapplication of patent law to the facts. It is asserted that in many such cases, issuance of a patent ought to have been denied on the basis that the claimed invention was either obvious, not novel, or both. Others respond that, while this may be true as a theoretical matter, it may be difficult to separate the question of the practical administrability of patent law criteria (such as non-obviousness, novelty, and utility) to tax law, from the overarching question of whether such patents ought to be permitted at all as a matter of public policy. The task of judging the merit of applications for tax strategy patents effectively calls upon patent examiners to become expert not only in a large and complex body of statutory and administrative tax law, but also potentially in the received wisdom and lore familiar to tax practitioners regarding how transactions are, in fact, routinely structured and executed in the real world. Although the Patent Office does not judge whether a patented tax strategy "works" from a tax law perspective, patent examiners still must determine whether a patent application satisfies the relevant criteria.

A closely related question concerns the appropriate definition of prior art for purposes of determining whether a tax strategy satisfies the novelty and non-obviousness requirements. Although the relevant statute does not expressly require the written publication of knowledge in order to establish prior art and defeat patentability,[103] case law requires some element of public

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[100] Indeed, this could give rise to ethical and professional conflicts for a lawyer, who could be forced into the uncomfortable position of choosing between (i) seeking the client's waiver of attorney-client privilege to approach the patent-holder about obtaining a license, (ii) refraining from advising the client to pursue a course of action which might otherwise be in the client's best interest in order to avoid either infringing the patent or waiving confidentiality of attorney-client communications, or (iii) willfully infringing the patent to preserve attorney-client privilege and satisfy the professional duty to diligently represent the client.

[101] The Physicians Immunity Statute is discussed in the "Patent Law and Background" section of this pamphlet, *supra.*

[102] Once again, this approach might still leave the actual taxpayer exposed to a possible infringement action.

[103] 35 U.S.C. sec. 102(a) provides that a person is entitled to a patent unless (among other requirements) "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" (emphasis added).

availability.[104] Patent examiners will typically rely on a library of written material in ascertaining "prior art." The reason generally given for the preference for publication is that the patent law system favors the disclosure of technical knowledge; in this framework, in close cases it is regarded as better to err on the side of granting a patent and forcing public disclosure, than rejecting a patent merely because others may have been practicing the claimed technology while (it might be suspected) trying to keep the details of the technology to itself (as in the case of "trade secrets," for instance). Whatever the merits of this approach, some observers argue that it is problematic to apply it in the context of legal and tax advice, where the failure to publicly disclose the details of a tax or other legal structure may have more to do with honoring the requirements of attorney-client privilege than with a suspected attempt to keep the technical knowledge hidden out of sight of the public sphere in order to effectively monopolize the superior technology outside of the patent system.

Practical issues regarding the application and administration of tax patents

The issuance of tax strategy patents raises a final set of questions and concerns that are independent of the foregoing policy considerations. For instance, when a tax advisor assists a taxpayer in implementing a patented tax strategy, have both the advisor and the taxpayer potentially infringed the patent? Similarly, when does infringement occur: when the advisor describes the structure to the client? At the time a patented structure or strategy is implemented? When the taxpayer files a tax return which reflects the tax savings of the structure? When that return is no longer subject to audit and challenge by the IRS?

If tax strategy patents continue to be granted, what obligations do tax advisors and taxpayers have to determine whether a particular strategy is subject to a patent? Conversely, given the confidential nature of tax returns, how can a patent-holder determine whether another taxpayer has infringed the patent by implementing the patented structure? Likewise, given the confidentiality of attorney-client communication (and, to a lesser extent, to communication with a tax practitioner), how can a patent-holder determine whether a tax practitioner (or a taxpayer) has infringed the patent?

In the event that tax patents continue to exist, these and similar questions must be addressed in a clear and uniform manner in order to provide order and certainty to taxpayers, tax advisors, and patent-holders alike.

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[104] For example, in *Gillman v. Stern*, 114 F.2d 28 (2d Cir. 1940), Judge Learned Hand, writing for the court, concluded that where a first inventor had kept his technology a trade secret and thus had not increased the store of public knowledge, the first inventor's prior use did not constitute prior art (and thus did not defeat the novelty of the technology with regard to a later inventor's attempt to patent the same technology).