THE STATE BAR OF CALIFORNIA
TAXATION SECTION
CORPORATE AND BUSINESS ENTITIES COMMITTEE[1]

TAX PATENTS

This proposal was prepared by Douglas L. Youmans, First Chair Elect of the Corporate and Business Entities Committee of the Tax Section of the California State Bar. The author wishes to thank Ellen P. Aprill, Associate Dean for Academic Programs, Loyola Law School and J. Timothy Maximoff, Esq., for their contributions to this paper.[2]

Contact Person: Douglas L. Youmans
Wagner Kirkman Blaine
Klomparens & Youmans LLP
10640 Mather Boulevard
Mather, CA 95655
(916) 920-5286

[1] The comments contained in this paper are the individual views of the author who prepared them and do not represent the position of the State Bar of California.

[2] Although the participants on the project might have clients affected by the rules applicable to the subject matter of this paper and have advised clients on applicable law, no such participant has been specifically engaged by a client on this project.

EXECUTIVE SUMMARY

From a public policy standpoint, it is inadvisable to allow tax patents because:

- They adversely impact the public's statutory obligation to pay taxes and undermine the uniform application of the tax law and the integrity of the tax system.

- They interfere with the ethical and moral obligations that tax advisors owe their clients and make it difficult for taxpayers to obtain advice.

- They discourage discussion of the tax law and tax planning alternatives and stifle useful innovation.

To eliminate, or at least to alleviate some, if not all of the aforementioned problems:

1. Congress should develop legislation to restrict the issuance of tax patents; limit taxpayer and tax advisor liability for tax patent infringement; and reduce the burden of proof for challenging tax patents or for defending patent infringement actions.

2. The U.S. Patent and Trademark Office ("PTO") should develop regulations which enhance access to and consideration of prior art by requiring all tax patent applications to be published; subject tax patents to challenge up to 12 months after being granted; and require disclosure to the IRS of all tax patent applications and all tax patent transactions.

3. The Internal Revenue Service ("IRS") should develop regulations which require disclosure to the IRS of all tax patent applications and all tax patent transactions.

I. BACKGROUND

Since State Street Bank and Trust Company v. Signature Financial Group, Inc.[3] held that a business method was patentable as long as it involved a "process" within the meaning of the Patent Act, patents are being increasingly sought and issued for various tax-related "inventions."[4] As patents confer rights to exclude others from making, using, selling or importing the patented "invention" during a 20-year period, numerous tax policy and administration issues have arisen with respect to tax patents, including:

- Do the objectives of the patent system justify imposing on taxpayers burdened by the significant costs and complexity of compliance with the tax law the additional costs, uncertainties and risks attributable to compliance with the patent law?

- Should the patenting of tax strategies be treated differently from other business method patents because tax patents impact the public's statutory obligation to pay taxes?

i. Do tax patents prevent taxpayers from exercising their rights to minimize their taxes within the limits of the law?

ii. Do tax patents deny taxpayers unrestricted access to all provisions of the Internal Revenue Code ("IRC")?

- If taxpayers consider the grant of a patent as governmental approval of the underlying tax strategy or tax advice, what remedial steps should be taken?

- Are patent examiners suited to judge novelty and non-obviousness by looking at published and publicly available prior art? [5]

---

[3] 149 F.3d 1368 (Fed. Cir. 1998)

[4] The PTO now classifies tax strategy patents as subclass 36T in Class 705, "Data Processing: Financial, Business Practice, Management or Cost/Price Determination." As of January 3, 2007, the PTO website lists 51 patents that have been issued in that subclass and 83 such applications pending.

[5] 35 U.S.C. § 101, et seq.

- Should patent examiners be permitted to consult others outside of the U.S. Patent and Trademark Office ("PTO") in examining tax patent applications?

- Should tax patent applications be published only if the applicant intends to seek protection abroad?

- What constitutes infringement of a tax patent?

  i. A tax advisor's advice to engage in a patented strategy?

  ii. A taxpayer's engaging in the transaction that employs the patented strategy?

  iii. A tax return preparer's preparation of a return reflecting the tax impact of the patented strategy?

  iv. The taxpayer's filing of that return?

- Can the Internal Revenue Service ("IRS") be held liable for infringement?

- What constitutes inducement of infringement of a tax patent? (Must the patent holder show that the inducer actually knew of the patent and intended to cause the infringement?[6])

A. U. S. Patent Act[7]

The Patent Act provides that a person may obtain a patent on an invention or process that is useful, novel, and non-obvious.[8] Once obtained, the patent confers on the patent holder the right to prevent others from using the patented process for 20 years.[9] The patent holder may bring a civil

---

[6] Lederman, Tax-Related Patents: *A Novel Incentive or an Obvious Mistake?* 105 J. of Tax 326 (Dec. 2006) (hereinafter "Lederman"), at p.330, citing Adams, "*A Brief History of Indirect Liability for Patent Infringement*", 22 Santa Clara Computer & High Tech. L.J. 369 (2006) (hereinafter "Adams"), pages 388-98; and Bush, Gartman, and Rogers, "*Six Patent Law Puzzlers*", 13 Tex. Intell. Prop. L.J. 1 (2004) (hereinafter "Bush, Gartman & Rogers"), pages 32-37.

[7] 35 U.S.C. § 101, et seq.

[8] 35 U.S.C. §§ 101, 102(a) and 103(a)

[9] 35 U.S.C. §§ 154(a)(2), 271 and 283

action against anyone who infringes or induces others to infringe upon the rights granted by the patent.[10] Although subject to challenge, a patent is presumed valid[11] and patent challenges are expensive to pursue.[12]

1. *Requirements for Patentability*

To obtain a patent, an invention must be useful, novel, and not obvious to one having "ordinary skill in the art."[13] A judicial determination that a patented process did not meet these three requirements constitutes a defense to an infringement action.[14]

With respect to novelty, the Patent Act precludes an inventor from obtaining a patent on a process that is known, used or sold by others, or patented or described in a printed publication (i) before the inventor's invention of the process;[15] or (ii) more than one year prior to the date of the application.[16]

For a process to lack novelty, it must be shown that each step was described in a single reference from the prior art.[17] Thus, the presence or absence of nonobviousness, rather than novelty, is likely to be the key to determining the validity of tax patents.[18]

The nonobviousness requirement precludes an inventor from obtaining a patent if the differences between the process sought to be patented and the prior art are such that the process would have been obvious

---

[10] 35 U.S.C. §§ 271 and 281

[11] 35 U.S.C. §§ 261; Roger E. Schechter and John R. Thomas, Principals of Patent Laws (West/Thomson, 2004) (hereinafter "Schechter and Thomas"), pp 252-257.

[12] In 2005, the American Intellectual Patent Law Association (AIPLA) reported that the average patent infringement cases typically cost $650,000 for each party when the amount at risk is less than $1,000,000 and $2,000,000 for each party when the amount at risk is between $1,000,000 and $25,000,000. Responding to Tax Strategy Patents, Presentation by Ellen Aprill at ABA 2007 Midyear Meeting, http://www.abanet.org/dch/committee.cfm?com=TX800000 (hereinafter "Aprill ABA Presentation").

[13] 35 U.S.C. §§ 101, 102(a) and 103(a)

[14] 35 U.S.C. § 282(2)

[15] 35 U.S.C. § 102(a)

[16] 35 U.S.C. § 102(b)

[17] 35 U.S.C. § 102

[18] Lederman, supra, at 330; Drennan, *The Patented Loophole: How Should Congress Respond To This Judicial Invention?* 59 Fla. L.J. 229, 259, note 138, (2007) (hereinafter "Drennan"), citing Donald S. Chisum, Chisum on Patents, note 25, at 532; and Pro-Mold & Tool Co. v. Great Lakes Plastics, Inc., 75 F. 3d 1568, 1573 (Fed. Cir. 1996).

to a person having ordinary skill in the art at the time the invention was made.[19]

2. *The Examination Process*

a. A patent application filed with the PTO must include:

i. A description of the invention (the "specification"), which describes it with sufficient clarity to enable one having ordinary skill in the art to make and use the invention without undue experimentation; and

ii. Claims that define the scope of protection sought. As the claims are the basis on which infringement will be determined, they must distinguish the invention from prior art.

b. Once filed, the patent application is assigned to a patent examiner to judge novelty and obviousness. However:

i. The PTO has a limited database of tax strategy prior art. Although regulations permit submission of prior art to the PTO within two months of an application's publication,[20] applications must be published only if the applicant intends to seek protection abroad[21] – protection which would appear to be unnecessary for a tax patent.

The PTO has established subclass 36T (Tax Strategies) of Class 705 (Data Processing: Financial, Business). Most tax patents can be found there.

---

[19] 35 U.S.C. § 103(a). This person who has "ordinary skill in the art" is a hypothetical person who has complete knowledge of all existing pertinent art who thinks along the line of conventional wisdom in the art, but who does not undertake to innovate. Drennan, supra, at 262, citing Custom Accessories, Inc. v. Jeffrey-Allan Indus., Inc., 807 F.2d 955, 962 (Fed. Cir. 1986), and In re Dow Chem.Co., 837 F.2d 469, 473 (Fed. Cir. 1988). See, also, Standard Oil Co. v. Am. Cyanamid Co., 774 F.2d 448, 454 (Fed. Cir. 1985); and Joint Comm. on Taxation, Background and Issues Relating to the Patenting of Tax Advice, JCX-31-06 (July 12, 2006) (hereinafter "Joint Committee Pamphlet") at 10. "The requirement of nonobiousness 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.' "

[20] Joint Committee Pamphlet, supra, at 14.

[21] Joint Committee Pamphlet, supra, at 14.

ii. As patent examiners have traditionally been engineers, it can be hard for them to judge novelty and obviousness for tax patents. Unfortunately, patent examiners cannot consult others outside of the PTO, even the IRS, while examining tax patent applications.[22]

3. *Infringement*

a. Infringement is the unauthorized making, using, or selling of the claims of an unexpired patent.[23] When dealing with tax patents, any/all of the following actions could constitute infringement: (i) the tax advisor's advice to engage in a strategy; (ii) a taxpayer's engaging in the transaction that employs the strategy; (iii) a tax return preparer's preparation of the return reflecting the tax impact of the strategy; and/or (iv) the taxpayer's filing of that return.

b. The remedy for infringement is a civil action against the infringer. Successful plaintiffs may be awarded injunctions and damages, even if the infringer had no knowledge of the patent.[24]

i. 35 U.S.C. § 154(a) allows the patent holder to stop others from making, using, offering to sell, or selling the process patented, or products made by that process, for the life of the patent.

ii. It is not a defense to an infringement action that the patent holder refused to license to the infringer. [25]

c. <u>IRS Liability</u>? 28 U.S.C. § 1498(a) specifically allows a patent holder to recover a reasonable license fee from a government agency that uses a patented process without permission. Thus, it is possible that the IRS could be liable for infringement if, for example, it used a patented process to verify or check a taxpayer's claims or calculations.

---

[22] 35 U.S.C. § 122(c)
[23] 35 U.S.C. § 271(a)
[24] 35 U.S.C. § 283
[25] 35 U.S.C. § 271(d)

4. *Inducement*

Anyone who actively induces infringement is liable as an infringer.[26] Thus, not merely individual taxpayers, but their attorneys, accountants, trustees, insurance agents, and other financial advisors all face potential liability for inducement. Similarly, corporations and their shareholders, officers, directors and tax advisors face liability, as do partnerships, their partners and tax advisors, and LLCs and their members, managers and tax advisors.

There is some question as to whether a patent holder must show that the inducer actually knew of the patent and intended to cause its infringement or merely show that the inducer intended to cause the infringement.[27] Given the current "low" level of knowledge among tax advisors of the scope of tax patents and patent protection, an interpretation that requires actual knowledge could limit application of inducement liability. Meanwhile, commentators are suggesting that tax advisors who fail to detect or advise clients about patents covering recommended tax strategies could be liable for malpractice.[28]

5. *First Inventor Defense Act of 1999*

Congress responded to criticism of State Street's allowance of business method patents in the First Inventor Defense Act of 1999.[29] If a defendant establishes by clear and convincing evidence that it "independently" reduced a business method to practice more than one year before the patent holder's patent application was filed, and that it had used the method commercially before the patent holder filed, the defendant is not

---

[26] 35 U.S.C. § 271(b); Moleculon Research Corporation v. CBS, Inc., 793 F.2d 1261 (CA-F.C., 1986).

[27] See Adams, supra, at, pages 388-98; Bush, Gartman & Rogers, supra, at pages 32-37; and Lederman, supra, at 330.

[28] "*Federal Case Highlights Debate Over Patenting of Tax Strategies*", 25 T.M. Weekly Report (BNA) 1104 (7/24/06) ("Whittier Law School professor Richard Gruner told BNA July 13 when practitioners unknowingly provide clients with tax advice that is patented, practitioners may not be exposed to court action but their clients may be"); Lederman, supra, at 330, citing Issues Relating to the patenting of Tax Advice: Hearing Before the Subcomm. on Select Revenue Measures of the House Committee on Ways & Means, 109th Congress (2006) (hereinafter "Tax Patent Hearings"), (statement of Ellen Aprill, Associate Dean for Academic Programs, Loyola Law School).

[29] P.L. 106-113, § 4302 (11/29/99), enacting 35 U.S.C. § 273

liable for infringement.[30] This defense, which is personal to the alleged infringer, does not establish that the patented method is invalid.

Unlike accused infringers of other business method patents, tax advisors might not be able to utilize the First Inventor Defense Act defense because of their obligations of client confidentiality and privilege under IRC sections 6713, 7216, and 7525, similar state law provisions, and any/all applicable codes of professional conduct. [31] Moreover, concern exists that the First Inventor Defense applies only to infringement, that it is not a defense to inducement. Hence, it might not be available for use by any tax advisors.

B. Difficulties Caused by Tax Patents

1. *Tax patents directly (adversely) impact the public's statutory obligation to pay taxes, and undermine the integrity of the tax system.*

a. If there is a business method patent pertinent to a business activity, a citizen has the choice to either: (i) pay for the right to use the technique; (ii) do the activity a different way; or (iii) not engage in the activity. Taxpayers do not have any such choice.

b. Tax patents preempt Congress's legislative control over tax policy. Congress enacts tax laws with the intention that taxpayers will be able to use them. Tax patents thwart Congressional intent by giving patent holders the power to decide how tax law can be used and who can use it.

---

[30] 35 U.S.C. § 273

[31] IRC §§ 6713 and 7216 generally prohibit tax advisors from sharing tax return information with third parties. Additionally, attorneys and CPAs are subject to both state regulation and codes of professional conduct, which have strict client confidentiality rules that would prevent them from sharing their previously implemented tax strategies with others. See, e.g., ABA Model Rules of Professional Conduct; California State Bar Act (California Business and Professions Code § 6000, et seq.); California State Bar, California Rules of Professional Conduct; AICPA Code of Professional Conduct; AICPA Statements on Standards for Tax Services; California Accountancy Act (California Business and Professions Code Division 3, Chapter 1, §§ 5000-5172); California Board of Accountancy, Accountancy Rules and Regulations, (California Code of Regulations; Title 16, Division 1, State Board of Accountancy) (hereinafter, collectively, "Professional Conduct Materials").

c. Tax patents deny taxpayers unrestricted access to all provisions of the IRC, and prevent taxpayers from exercising their rights to minimize their taxes without having to pay any surcharge or royalty.

"Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible . . . nobody owes any public duty to pay more than the law demands, taxes are enforced extractions, not voluntary contributions."[32]

At best, a tax patent requires a taxpayer to pay a "surcharge" to the patent holder, increasing the taxpayer's compliance costs. At worst, the patent holder could refuse to license the tax strategy, blocking the taxpayer's ability to comply with the law. The economic advantage enjoyed by the tax patent holder flows not from providing better goods and services, or from finding a more efficient way of providing goods and services, but from developing a better way to secure tax benefits from the government. One of the quickest, easiest ways to undermine the integrity of a tax system is to create the perception, if not clearly demonstrate that it treats similarly situated taxpayers differently.

d. Once a taxpayer has concluded a transaction, the return preparer and the taxpayer are legally obligated to properly reflect the impact of the transaction on a return, even if the transaction constitutes an infringement. It should be against public policy to allow either an action legally taken to minimize the tax due on a return, or the preparation and filing of a legally required return to constitute infringement.

2. *The patenting of tax strategies makes it difficult for tax advisors to render advice due to concerns that techniques they might recommend might infringe.*

a. Tax advisors face a dilemma due to the facts that conducting a patent search may increase the possibility of treble damages for knowingly inducing infringement, while failure to do a search could increase malpractice exposure. This dilemma could place an unreasonable burden on taxpayers whose tax advisors may advise them to retain patent counsel

[32] Comm'r v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting); *see also* Rothschild v. United States, 407 F.2d 404, 413 (Ct. Cl. 1969); Turner Constr. Co. v. United States, 270 F.Supp. 918, 927 (S.D.N.Y. 1964); Gregory v. Helvering, 293 U.S. 465, 469 (1935); and Vinson & Elkins v. Comm'r, 99 T.C. 9, 57 (1992).

simply to file their tax returns. The complexity and cost of determining whether a relevant tax patent exists and, if so, negotiating for and paying a license fee might cause some taxpayers and their advisers to abandon a strategy under the belief that it is patented (e.g., where the cost of retaining tax counsel and payment of the license fee exceed the anticipated value of the benefit of the patented strategy).

b. Due to the fact that patent applications need not be published until at least 18 months after they have been filed, and some can be kept completely private, there is a period of time when it is impossible for taxpayers and their advisors to know whether any tax strategy under consideration could have any potential infringement ramifications.

3. ***Tax advisor privilege and tax return confidentiality make it difficult to demonstrate prior art in infringement suits and in presenting evidence to the PTO in opposition to patent applications.***

a. In general, tax return information is confidential[33] and communications between taxpayers and their tax advisors are privileged.[34] Confidential client tax return information cannot be used to show a prior reduction to practice or commercial use of the method before the filing date of the patent without the "other"/"prior" client's permission (which is unlikely to be granted out of concern regarding the prior client's exposure to audits and/or infringement actions). Likewise, without client permission, confidential return information cannot be used to prove a patented tax strategy has been previously utilized and is not novel. Such constraints on the ability of tax advisors to defend themselves against infringement claims place them in a position of potential exploitation by patent holders that is not faced by users of other types of business method patents.

4. ***Tax patents interfere with the ethical and moral obligations that tax advisors owe their clients to represent them to the full extent of the law.***

a. When providing tax advice, tax advisors have professional and fiduciary obligations to act in their clients' best interests

[33] I.R.C. § 6103(a).
[34] I.R.C. § 7525(a)(1).

and to put their clients' interests ahead of their own.[35] When a patent holder seeks to restrict a tax advisor from utilizing a strategy that would be in a client's best interests, the patent holder interferes with the tax advisor's fiduciary obligations as the tax advisor could be forced to choose between advising the client to violate patent law and violating his or her fiduciary duty to his or her client.

b. Circular 230[36] prevents tax advisors from representing clients before the IRS if the representation involves a conflict of interest. A conflict of interest exists if there is a significant risk that the representation of a client will be materially limited by the practitioner's responsibilities to another client or former client, a third person, or by a personal interest of the tax advisor. The tax advisor's interest in protecting himself or herself from an infringement suit could prevent him or her from representing a client before the IRS.

5. ***Tax patents threaten the IRS's ability to enforce the law, as patents are granted without ensuring that they are compliant with the IRC.***

Patents may be issued that are not fully compliant with tax law. Such patents could lead taxpayers to believe they have a "seal of approval" from the government, which could hurt compliance and increase the administrative burden on the IRS as it will be difficult, if not impossible, to "teach" unsuspecting taxpayers that a patent does not carry with it IRS authorization.

6. ***Tax patents could discourage tax advisors from attending conferences and discussing tax issues with other professionals out of fear that they will be exposed to infringement liability or otherwise alert tax inventors or patent holders of their interest in a particular tax strategy.***

Traditionally, tax advisors have worked together to develop tax strategies through tax committees of the ABA, the AICPA, state

---

[35] See, e.g., Professional Conduct Materials, supra.

[36] Treasury Department Circular No. 230 (Rev. 6-2005), *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service*, Department of the Treasury Internal Revenue Service, Title 31 Code of Federal Regulations, Subtitle A, Part 10, revised as of June 20, 2005. *See* § 10.29(b)(2).

and local bar and accounting associations, and other groups. This approach has enabled tax advisors to deliver "cutting edge" tax advice to a greater number of taxpayers. The existence of tax patents could have a chilling effect on the collegial nature of the tax practice. For example, practitioners seeking patent protection may decide not to publish or discuss their ideas until a patent is issued. By limiting the free flow of discussion, tax patents will hinder, rather than advance, the discovery of new tax strategies. This stifling of innovation is contrary to the intent of the Patent Act and the U.S. Constitution.[37]

7. *Many professionals (particularly lawyers) are becoming increasingly concerned that other legal strategies will start being patented as business methods.*

Historically, the law has been viewed as an "open range" that should not be fenced off into private domains.

II. WHAT CAN BE DONE TO ADDRESS THE PROBLEMS CAUSED BY TAX PATENTS?

A. Congress

1. *Possible Patent Law Amendments*

In a written statement presented to the House Ways and Means Subcommittee on Select Revenue Measures in July 2006, James Toupin, general counsel of the PTO, reminded lawmakers that the definition of "patentable subject matter" begins with legislation.[38]

a. In general, Congress has two legislative options for tax strategies: it can bar patent protection, such as 42 U.S.C. § 2181 bars patent protection for inventions that are "useful solely in the utilization of special nuclear material or atomic energy in an atomic weapon"; or it can limit available remedies, similar to the way patent-holders are prohibited

[37] U.S. Const. art. I, § 8; *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 146 (1989).

[38] Tax Patent Hearings, supra, (Statement of James Toupin, general counsel of the PTO).

from collecting damages from health care practitioners and related entities for infringement of medical procedure patents.[39]

b. Alternatively/additionally, legislation similar to the Business Method Patent Improvement Act of 2000[40] (the "Patent Improvement Act") could be adopted to help the PTO "weed-out" tax patents which are not novel or nonobvious, or which have no economic substance and are not useful. The Patent Improvement Act would have:

- Required tax patent applications to be published 18 months after filing. Once published, any member of the public could submit relevant prior art, file a protest, or petition the PTO to conduct a proceeding to establish lack of novelty or nonobviousness.

- Subjected tax patents to challenge up to nine months after being granted.

- Reduced the burden of proof for challenging tax patents or for defending infringement actions from the standard of "clear and convincing" evidence, to a mere "preponderance."

- Required the applicant to disclose relevant prior art and to reveal the extent to which prior art was searched.

2. *Possible IRC Amendments*

a. The IRC could require that the IRS and the Treasury be promptly informed of all tax patent applications. If any such application disclosed an abusive or aggressive interpretation of the law, the IRS could take prompt remedial action. Even if the application described a legitimate interpretation of the law, the IRS and Treasury would have the opportunity to ascertain and evaluate the potential impact of the patent on the tax system and to consider whether legislative or administrative responses are warranted. Accordingly, the IRC should require that, whenever a tax patent application is filed, the applicant is to send a copy to

[39] 35 U.S.C. § 287(c).
[40] H.R. 5364 (10/3/00)

the IRS under the same conditions of confidentiality that apply to patent applications submitted to the PTO.[41]

b. To help develop prior art and mitigate against the granting of "obvious" patents, Congress could specify language in legislative history that anticipates possible patents whenever a new tax law is enacted. (If the legislative history of the GRAT provisions had noted Congress anticipation that GRATs could be funded with any appreciating asset, the SOGRAT patent application might have been denied as obvious.[42])

B. Possible PTO Regulatory and Procedural Reform

1. *The PTO can adopt special procedures for dealing with tax patent applications.*

a. The PTO could hire experienced tax attorneys to examine applications so that, to the extent it is presented, patentable subject matter can be fairly reviewed.

b. To improve procedures for submission of prior art to and review of prior art by the PTO, the PTO can require that all tax patent applications be disclosed.

c. To enable advisors to have sufficient time to submit evidence of prior art, current PTO regulations permitting submission of prior art to the PTO within two months of a patent application's publication should be increased to one year.

d. To ensure all taxpayers and return preparers have full access to the IRC, the PTO can require all tax patent holders to license their patents.

C. Possible IRS Regulatory and Procedural Reform

1. *Tax patents could be listed as "reportable transactions."*

---

[41] Such a law would enable the PTO to share all tax patent applications with the IRS: Patent law allows disclosure of patent applications if "necessary to carry out the provisions of an Act of Congress." 35 U.S.C. § 122(a).

[42] Aprill ABA Presentation, supra, http://www.abanet.org/dch/committee.cfm?com=TX800000

A new category of reportable transaction (a "tax patent transaction") could be established under IRC § 6011 and the regulations thereunder to inform the IRS about the use of tax patents purporting to provide a reduction in tax or other substantive tax result. Taxpayers could be required to report their participation in any transaction that uses such strategy for each taxable year for which the taxpayer's return reports an item attributable to such a transaction.[43] However, in order to be a reportable transaction, the taxpayer must, at the time the return is filed, knowingly have a legal right to use the tax patent. Thus, if a taxpayer unwittingly engages in a tax strategy that has been patented, or decides to proceed without obtaining the legal right to utilize the patent at the time the return is filed, the taxpayer would not be considered to have participated in a tax patent transaction.

a. Use of patented methods or processes for complying with return preparation and filing or other administrative or compliance requirements should not constitute reportable transactions.

2. *The "Material Advisor" rules could be expanded to include persons who (i) license tax patents to others; or (ii) issue statements regarding tax patents.*

If "tax patent transactions" become reportable transactions, the definition of "material advisor" with respect to tax patent transactions should be expanded to include persons who: (i) license to others the right to use a tax patent or who otherwise provide a service described in Prop. Reg. § 301.6111-3(b)(1) with respect to such activity; (ii) communicate any aspect of the tax consequences to be derived from implementation of the tax-related claims made in the tax patent; and (iii) meet the "threshold amount" requirements. (See Prop. Reg. § 301.6111-3.)

As the ABA Section of Taxation has pointed out,[44] the threshold amount requirements for material advisor status with respect to tax patent transactions are problematic in that they would appear to exempt most potential material advisors. Hence, lower threshold amounts will need to be established and consideration should be given to aggregating all income

[43] See Prop. Reg. § 1.6011-4(c)(5); compare Prop. Reg. § 301.6111-3(c)(6).

[44] The ABA Section of Taxation, February 21, 2007 letter to IRS Commissioner Mark Everson, containing comments concerning a new category of reportable transaction covering patented tax strategies.

derived by a potential material advisor with respect to a tax patent during a calendar year, without regard to the number of ultimate taxpayers involved.

III. WHAT SHOULD BE DONE TO ADDRESS THE PROBLEMS CAUSED BY TAX PATENTS?

Of the various alternative means of addressing the numerous problems tax patents are causing, for the reasons indicated, it is the author's opinion that the following legislative/regulatory solutions should be implemented:

A. Congress

1. *Suggested Patent Law Amendments*

a. Restrict the PTO from Issuing "Tax Savings" Patents

While, initially, a complete bar of patent protection for tax strategies might appear to be appropriate because of the long list of problems associated with tax patents, an absolute prohibition on all tax-related "inventions" would have at least a couple of unfavorable consequences.

First, tax patents that deal with compliance, bookkeeping, and return preparation are not harmful. IRS Commissioner Everson has stated that patents in these areas can be beneficial in improving taxpayer compliance. [45] If Congress were to prohibit issuance of tax related patents, these helpful compliance/reporting processes would be lost.

Second, a complete prohibition of all tax patents would encompass inventions that have some economic or business benefits and incorporate only some minor tax feature or aspect.

Hence, in lieu of an absolute prohibition of all tax patents, legislation should provide that patents will not be issued for patents for tax strategies based on (i) interpretations of federal, state, or local tax

[45] Tax Patent Hearings; supra, (statement of Mark Everson, Commissioner, IRS) ("[T]ax administration could in fact benefit from the granting of patents to tax products that facilitate the ability of taxpayers to plan and conduct their tax affairs in compliance with the law.").

laws; (ii) application of tax principles; and/or (iii) structuring of transactions and/or ownership of property which assist taxpayers in avoiding, deferring or minimizing tax (hereinafter, all such tax strategy patents being referred to, collectively, as "Tax Savings Patents"). Specifically carved out of this prohibition should be patents for software that deals with tax compliance and bookkeeping which helps perform administrative tasks associated with preparing returns (hereinafter, "Compliance Software"). Such Compliance Software should not be prohibited because it does not undermine Congressional authority, create any exclusivity in interpreting tax law, cause similarly situated taxpayers to be treated/taxed differently or otherwise interfere with tax advisors' abilities and obligations to represent their clients.

i. Senate Bill 1565 (Levin, Coleman and Obama), the Stop Tax Haven Abuse Act, which would prohibit the PTO from issuing patents intended to "minimize, avoid, defer, or otherwise affect liability for federal, state, local or foreign tax," would appear to prohibit most of the Tax Savings Patents which should be prohibited. However, its broad language would appear to encompass Compliance Software, patents on which the author believes should be permitted.

b. Provide Immunity from Patent Infringement Liability for Taxpayers and Tax Advisors

In addition to banning Tax Savings Patents, in order to mitigate the problems which have been/will continue to be caused by any tax patents issued before legislation is enacted prohibiting issuance of Tax Savings Patents, legislation should provide that tax advisors who disseminate tax advice and taxpayers who implement tax strategies cannot be sued for infringement. Similar to the immunity the medical community obtained as part of the Omnibus Consolidated Appropriations Act of 1996,[46] such legislation would deprive patent holders of all monetary and injunctive remedies. However, this immunity would be an even more appropriate solution in the tax context than in the medical context as only the professionals performing the medical procedures had to worry about infringement -- patients could not infringe. Here, absent change, as previously noted, the taxpayers themselves can be liable for infringement (not just their tax advisors).

[46] 35 U.S.C. § 287(c)

Alternatively, Congress should at least prohibit injunctive relief and the collection of damages based on tax savings from patent infringement. Thus, if a taxpayer enjoys no benefit other than tax savings from using a tax patent, the taxpayer can use the patent without fear of having to pay damages for infringement. On the other hand, if the taxpayer enjoys non-tax economic benefits, the taxpayer may be required to obtain a license or pay damages for infringement. Under this sort of limited immunity, tax advisors and taxpayers could evaluate whether to use tax patents to realize tax savings or to obtain non-tax economic advantages. This limited immunity could remove the PTO from a portion of the tax patent quagmire, allowing it to issue tax-related patents without causing as much concern about tax patents which are not novel or nonobvious, or which have no economic substance and are not useful.

c. Alternatively/additionally, particularly if Tax Savings Patents are not prohibited, for the reasons outlined above, legislation similar to the Patent Improvement Act should be adopted to:

- Require all tax patent applications to be published 18 months after filing.

- Subject tax patents to challenge up to 12 months after being granted.

- Reduce the burden of proof for challenging tax patents or defending infringement actions from the standard of "clear and convincing" evidence, to a mere "preponderance."

- Require applicants to disclose relevant prior art and to reveal the extent to which prior art was searched.

2. *Suggested IRC Amendments*

a. For the reasons previously mentioned, particularly if Tax Savings Patents are not prohibited, the IRC should require that the IRS and the Treasury be promptly informed of all tax patent applications, and that, whenever a tax patent application is filed, the applicant is to send a copy to the IRS under the same conditions of confidentiality that apply to patent applications submitted to the PTO.

b. If Tax Savings Patents are not prohibited, for reasons stated above, Congress should specify language in legislative history that anticipates possible patents whenever a new tax law is enacted.

B. Suggested PTO Regulatory and Procedural Reform

1. *For reasons mentioned previously, particularly if Tax Savings Patents are not prohibited, the PTO should adopt special procedures for dealing with tax patent applications.*

a. The PTO should hire experienced tax attorneys to examine applications; require that all tax patent applications be disclosed; extend the time for submission of prior art from two months to one year after the application's publication; and require all tax patent holders to license their patents.

C. Suggested IRS Regulatory and Procedural Reform

1. *For reasons outlined above, tax patents should be considered reportable transactions.*

a. A new category of reportable transaction (a "tax patent transaction") should be established on the terms previously outlined.

2. *For reasons already mentioned, particularly if Tax Savings Patents are not prohibited, the "Material Advisor" rules should be expanded to include persons who (i) license tax patents to others; or (ii) issue statements regarding tax patents.*

a. If the definition of "material advisor" is expanded on the terms outlined above, lower threshold amounts will need to be established and all income derived by a potential material advisor with respect to a tax patent during a calendar year should be aggregated without regard to the number of ultimate taxpayers involved.

IV. CONCLUSION[47]

Even though the patent system has provided the incentives to invent, commercialize, design around, and disclose new inventions the Founding Fathers originally intended, there is no need to give tax inventors further incentive to propagate an already abundant supply of tax saving strategies. Consequently, action must be taken to eliminate, or at least to alleviate some, if not all of the aforementioned problems, for at least three reasons:

- First, the policy rationales that support patents in other industries do not apply to Tax Savings Patents because Tax Savings Patents do not improve the general quality of life for society as a whole, make the U.S. economy stronger, or improve the U.S. trade balance.

- Second, by granting Tax Savings Patents, the PTO is frustrating the Treasury's efforts to reduce economic incentives to invent and commercialize tax strategies which have no economic substance—the Treasury and the PTO should not be moving in opposite directions.

- Third, Tax Savings Patents violate the policy that similarly situated taxpayers should not be treated differently, [48] and Congress should not allow tax inventors to use the PTO as a tool to propagate even the slightest of hint that the tax law is being inconsistently and/or antithetically applied.[49]

---

[47] The author generally concurs in the views expressed by IRS Commissioner Mark Everson, Professor Ellen Aprill, and Mr. Dennis Belcher, who testified at the July 13, 2006 Tax Patent Hearings; the New York State Bar Association Tax Section's August 17, 2006 letter to the leadership of the tax-writing Committees and Subcommittees; the ABA Tax Section's February 17, 2007 letter to IRS Commissioner Mark Everson; and the AICPA Tax Executive Committee's February 28, 2007 letter to the leadership of the tax-writing Committees and Subcommittees; the Virginia Society of Certified Public Accountants October 6, 2006 letter to the AICPA Board of Directors; the Texas State Bar and the Texas State Bar Section of Taxation's January 26, 2007 Resolution in Support of Amending 35 U.S.C. § 287; the Texas State Bar Section of Taxation's January 29, 2007 letter to Assistant Treasury Secretary for Tax Policy, Eric Solomon and IRS Commissioner Mark Everson; and the Colorado State Bar's March 5, 2007 letter to Senators Obama, Levin and Coleman.

[48] IBM Corp v. U.S., 170 Ct. Cl. 357, 343, F.2d 914, 15 AFTR 2d 1526, 654 USTC ¶ 15,629 (Ct. Clms. 1965)

[49] To tweak a phrase coined by our forefathers on the eve of the American Revolution, "No taxation without uniform application!"