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“Patenting tax strategies: A troubling storm develops”

Warning: Tax strategies are now being carved out as private property, patented through the U.S. Patent Office.

The practice started with a trickle in 1998, and is now becoming a steady stream threatening to overflow its banks. How does this development affect the tax practitioner? Will a practitioner be subject to a patent infringement suit for using a particular technique that has been “making the rounds?” Should practitioners begin applying for patents on strategies that they have discovered in solving a particularly thorny problem for a client?

The problems surrounding the patenting of tax strategies have caught the eye of Congress. The Subcommittee on Select Revenue Measures of the House Ways and Means Committee held a hearing in mid-July to uncover and start addressing the issues relating to the patenting of tax advice.

While members of the subcommittee are reserving judgment until they all meet privately and air their views, the tone of the questioning and closing comments indicated that changes may be forthcoming.

Patent basics

Patentable items have come a long way since the electric light bulb (Patent No. 223,898). Patents may be obtained on processes, machines, manufactures and composition of matter that are useful, novel and non-obvious. Once granted, a patent enjoys a presumption of validity. An accused infringer may assert that a patent is invalid or unenforceable on a number of grounds, including prior use and non-patentability.

The development of patents on tax strategies started with the groundbreaking case that first allowed business method patents, State Street Bank (149 F.3d 1368 (1998), in which the Federal Circuit held that a method of doing business was patentable subject matter. That patent application involved a data-processing system for mutual fund investments that used a partnership structure to allocate income and expenses and make daily calculations of partnership interest and share prices, as well as year-end calculations for tax and accounting purposes.

From that controversial beginning, over 8,000 applications for business methods are now filed each year. As with State Street, many of these patents incorporate structures that add benefits to their desirability. With this background, the leap to allowing the patenting of strategies in which tax considerations predominated, therefore, may have been inevitable.

Tax patents

Since 1998, the U.S. Patent and Trademark Office has issued 41 patents relating to tax advice. Some 60 tax advice patent applications are pending. A variety of tax patents have been granted. They point to the evolution of tax patents from ones exclusively based on the use of computers to strategies based on structure-based processes. The latter category had been confined primarily to the estate planning area, but lately has seen development into compensation and corporate reorganization matters.

One tax patents being discussed lately, the so-called SOGRAT, has raised particular concern because it is driven by a non-computerized strategy. “Establishing and managing grantor-retained annuity trusts funded by nonqualified stock options,” Patent No. 6,567,790, was granted May 20, 2003, to facilitate estate planning. The unique feature of this GRAT is the use of nonqualified stock options to fund it, and the sequential valuations of those options in coordination with each annuity payment.

The SOGRAT patent is currently the subject of litigation in federal court based on alleged infringement (Wealth Transfer Group v. Rowe, No. 06CV00024, D. Conn., filed Jan. 6, 2006). Reportedly, at least one financial institution has backed away from using a SOGRAT technique suggested in its newsletter to clients after the patent holder saw the article and threatened to sue. The cost of litigation, rather than the merits of the case, apparently persuaded the institution to abandon use of the strategy entirely.

Tax patents that have been granted so far in the structure-based strategies category typically involve a series of complex steps that unlikely would be precisely imitated without direct reference to the patented materials. Other applications, however, purportedly are becoming less intricate. The SOGRAT strategy appears to fall in the middle of the spectrum. In either case, how close other practitioners can come in using the same sequence and combination of code provisions to customize a strategy for their clients remains an issue.

Pros and cons

The pros and cons of issuing tax patents can serve as a roadmap to the current considerations that tax practitioners must weigh. A summary of the current debate may point to possible solutions.

IRS Commissioner Mark Everson in his testimony before the subcommittee warned that a proliferation of tax patents could lead to IRS enforcement problems if the practice effectively sanctions abusive tax schemes. In making this point, he underscored a blatant shortcoming of the patent process as related to tax practice: A patent strategy may not successfully deliver the tax result that it promises. The Patent Office does not rule on the results, and the IRS will not address them specifically except in connection with an individual taxpayer’s request for a letter ruling or in connection with an individual’s audit. For the IRS to start approving the tax results of each patent would pose an impossible administrative burden, argues a recent Joint Committee on Taxation report.

Without further legislative or administrative action, tax shelter promoters may circumvent the reportable transaction regulations by patenting a tax strategy. One category of listed transaction requiring disclosure by the taxpayer using it (and, therefore, a red flag for the IRS) is the “confidential transaction.”

Since patents are a matter of public record, their use would no longer constitute a confidential transaction. Rather than prohibit tax patents altogether, however, one solution would be for the IRS to revise its listed transactions roster to included tax-patent transactions.

The most significant argument against the patenting of tax strategies is that it can amount to the private capture of public tax law. The problem is put succinctly by JCX-31-06: “The focus oft these concerns is 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.”

Current situation

A variety of recommendations have need made that would continue the benefits of patenting strategies while limiting its downside. They include:

- ❖ Hiring more tax-savvy examiners at the Patent Office who would be dedicated to sorting out the merits of each tax application:
- ❖ Passing an immunity statute for practitioners similar to the existing Physicians Immunity Statute that bars damages against a licensed practitioner in connection with the performance of a patented procedure;
- ❖ Defining more clearly the due diligence expected of the tax advisor and the client for conducting a patent search before providing or accepting tax advice;
- ❖ Balancing the ability to prove “prior art” in using a tax strategy with the secrecy expected from an attorney-client or tax advisor-client privilege;
- ❖ Requiring strict disclosure rules in marketing patented tax strategies to investors; and,
- ❖ Restricting patents to software designed for administration and compliance purposes.

Conclusion

Where will it all end?

The prospect of legislation to control the implications of the expanding universe of tax patents seems likely. On his way out of the July hearing, subcommittee chair David Camp commented that he would attempt to determine whether there is consensus on the need to introduce legislation that would define a distinction between “tax planning methods” and “tax planning strategies.” The goal is to curtail or stop the patenting of tax advice.

“I think that’s where we need to start,” he said. He questioned whether the patenting of tax advice is fair to taxpayers, and referred to the practice as tantamount to requiring a royalty to comply with the law.

Subcommittee member Rep. Stephanie Tubbs Jones, D-Ohio, echoed that concern, stating, “As much as I love innovation and ingenuity, I find it troubling that you can put a patent on tax advice.”

For the time being, estate planning is the most likely practice area that risks patent infringement litigation. Real estate and corporate mergers and acquisitions reportedly are also becoming at risk.

In any case, however, advisor-client confidentiality may form the most effective barrier for that moment against aggressive infringement litigation. Rainmaking by marketing a tax strategy publicly thorough a firm’s newsletter, public speaking engagements, or otherwise, by contrast, may have the distinct downside of alerting a patent holder to someone on whom the currently uncertain law on infringement of tax patents can be tested.