HEARING ON ISSUES RELATING TO THE PATENTING OF TAX ADVICE

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

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HEARING ON ISSUES RELATING TO THE PATENTING OF TAX ADVICE

THURSDAY, JULY 13, 2006

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:30 a.m., in room B–318, Rayburn House Office Building, Hon. Dave Camp (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE CONTACT: (202) 226–5911
June 27, 2006
SRM–9

Camp Announces Hearing on Issues Relating to the Patenting of Tax Advice

Congressman Dave Camp (R–MI), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on issues relating to the patenting of tax advice. **The hearing will take place on Thursday, July 13, 2006, in B–318 Rayburn House Office Building, beginning at 10:30 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Subcommittee and for inclusion in the printed record of the hearing.

BACKGROUND:

In recent years, patents for "business methods" have been issued by the Patent and Trademark Office. A number of patents have been issued for tax reduction strategies, particularly in the area of estate and gift taxation.

In announcing the hearing, Chairman Camp stated, "This hearing is an opportunity to explore a relatively recent phenomenon. At first glance, it seems odd that anyone should be permitted to patent means of complying with federal law. While intellectual property experts rightly note that patents can help promote the development of new technologies and ideas, tax practitioners have expressed concerns about giving one person the ability to charge others for using relatively common structures. We also need to get a sense of whether patents may contribute to tax avoidance schemes which make the IRS's job of blocking tax shelters more difficult in the long run."

"There are no preconceived goals here," Camp noted. "We want to explore this development and that's why we're inviting the IRS, the Patent and Trademark Office, academicians and practitioners to give us their views of the practice."

FOCUS OF THE HEARING:

To explore issues relating to the issuing of patents for tax reduction strategies, particularly in the area of estate and gift taxation.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record*." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Thursday, July 27, 2006. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

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The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman CAMP. Good morning, the Committee on Ways and Means on Select Revenue will come to order. Today, we will explore a relatively recent phenomenon, patenting tax methods and strategies. To date, only a few patents have been issued for business methods involving the Tax Code. However, we are examining what the practice might mean to taxpayers and the legislative process if it expands. This hearing is about the overlap of two important Federal policies: patents and general tax compliance. With patents, the government seeks to promote public access to innovative products and developments by providing inventors with the ability to control the use of an invention for a period of years. Tax legislation is generally written with the idea that the rules, and particularly those rules that provide benefits, ought to be equally available to every eligible taxpayer.

Our panelists have been invited to provide us with an overview of how key government agencies are dealing with this phenomenon and perspectives on potential pluses and minuses such patents may have. There are two major issues we will explore with them. First, does the existence of a patent appear to legitimize an otherwise inappropriate tax arrangement and thereby contribute to tax compliance problems or, worse, create a misunderstanding of our tax laws. Second, and perhaps more important over the long term, is the effect of patents on taxpayers seeking to comply with enacted laws intended to benefit broad groups.

Our first panel includes James Toupin, general counsel of the Patent and Trademark Office (USPTO) and an individual well known to many of us, Internal Revenue Service (IRS) Commissioner Mark Everson. Their agencies have been working together on matters related to tax patents, including increasing scrutiny and awareness.

The second panel includes Members of the academic community, Professor Richard Gruner, who teaches intellectual property and Whittier Law School; and Professor Ellen Aprill, who teaches tax law at Loyola Law School in Los Angeles. Our third witness, Dennis Belcher, is a partner at the McGuireWoods Law Firm, who practices estate and trust administration and estate planning, as well as serving as the secretary of the American College of Trust and Estate Counsel. He will offer a perspective from the practitioner's point of view. The panel will give Members an opportunity to evaluate the pros and cons of patenting tax compliance concepts and views on what might be done to expand the transparency of the patent process to reduce risks to taxpayers.

I would now yield to the Ranking Member, Congresswoman Stephanie Tubbs Jones, for any remarks she would choose to make.

Ms. TUBBS JONES. Any day I could be Ranking Member or a Chair, I can't wait, okay. Hi, everybody.

Chairman CAMP. Let's hope it is a little bit of a wait.

Ms. TUBBS JONES. Okay, all right. No offense, Dave. In 1998, the U.S. Court of Appeals' decision held that tax strategies and financial products could be protected as patentable "business methods." This has led to the issuance of about 40 tax patents by the U.S. Patent and Trademark Office, and 60 more are pending. I could go on and read this but everybody knows why we are here. I will submit this written opening statement for the record. I am pleased to have the opportunity to get engaged in this discussion. When I realized this is what we were going to do, I called a couple of my friends who do patent work and then some who did tax work. They said, "We are not paying any attention to that." I said, "Wait a minute, it is important." So, I sent them the information, I am hoping to get some outside response to this whole issue.

Gentlemen, I am glad to have you both here. If you see me slip out, it is only for a moment. All of you recognize that the Voting Rights amendment Act (P.L. 109–246) is being debated this morning, and I have got to go put my two cents in. Once I do that, I will go and come back. I am really interested, and I thank the Chairman for calling this hearing. I think it is going to be very interesting.

[The prepared statement of Ms. Tubbs Jones follows:]

In 1998, a U.S. Court of Appeals decision held that tax strategies and financial products could be protected as patentable "business methods." This has led to the issuance of about forty tax advice patents by the U.S. Patent and Trademark Office, and sixty more are pending. These patents involve, for example, techniques for converting a regular IRA to a Roth IRA, creating tax-deferred real estate exchanges, enhancing donations of artwork through a tax-exempt organization, performing tax computations and tax-advantaged transactional structures, and converting future

Social Security payments into current benefits. The most controversial patent to the tax practitioner community is called SOGRAT.

It involves techniques for transferring appreciated assets to family Members while incurring minimal estate and gift taxes. Such a patented estate tax strategy, and others that are not patented but are still common, begs the question of whether we need to eliminate or drastically reduce the estate tax. That said, I think that the following basic issues should be addressed at this hearing: At the outset, should tax advice be eligible for a patent—as an "invention" based on interpretation of the Tax Code and IRS regulations? Should tax patent holders be able to control, and potentially profit from, application of the tax laws as enacted by Congress? What role does the IRS have to ensure that aggressive tax schemes or illegal shelters do not receive patents? Are tax patents being used as marketing tools to mislead taxpayers into believing that the product they are buying has a federal government "seal of approval?"

I look forward to discussing these issues with the Internal Revenue Service, the U.S. Patent and Trademark Office, and the tax experts joining us today as witnesses. Thank you, Mr. Chairman, I yield back the balance of my time. Chairman Camp. Thank you. Again, I also want to welcome our witnesses. We will start with Mr. Toupin. Thank you both for being here. I know you have very busy schedules. We have your full statements, those will be part of the record and you can summarize those in 5 minutes. You now may begin. Thank you for being here.

STATEMENT OF JAMES TOUPIN, GENERAL COUNSEL, U.S. PATENT AND TRADEMARK OFFICE

Mr. TOUPIN. Chairman Camp, Ranking Member Tubbs Jones, members of the Subcommittee, thank you for inviting me to testify today on the patenting of business method inventions concerning tax strategies. I appreciate the opportunity to provide some background on the subject, which I hope will be helpful to the Subcommittee.

In administering the U.S. patent laws, the USPTO takes its direction from Congress and our reviewing courts. The current act specifies four basic statutory requirements that must be met to obtain a patent. The claimed invention must define eligible subject matter and have utility. It must be novel. It must not have been obvious to a person having ordinary skill in the art at the time the invention was made. It must be sufficiently disclosed in the text of the patent application to show that the inventor had possession of the claimed invention upon filing, and the skilled practitioner would be able to practice the claimed invention without undue experimentation. The threshold inquiry as to whether subject matter is eligible to receive patent protection is whether an invention is new and useful and whether it fits into one of the enumerated categories, which includes any process, machine, manufacturer or composition of matter or any new and useful improvement thereof.

As discussed in greater detail in my written statement, the courts have recognized the breadth of this statute. In particular, the Court of Appeals for the Federal Circuit in the 1998 decision in State Street v. Signature Financial explicitly rejected the notion that a business method exception exists in United States patent law. It thus ended any notion that inventions deemed to be business methods, by whatever criteria, would be excluded from patent ability on that basis alone. State Street created a new awareness that business method claims could be patented. Patent applications in that area went from 1,500 filings in Fiscal Year 1998 to approximately 9,000 filings in Fiscal Year 2001. Filings are currently running at a somewhat lower rate of 8,200 filings a year.

This expansion of business method patent applications created challenges for the USPTO and the business community. Because business methods had been commonly not regarded as eligible for patenting, examiners did not have available to them a large database of prior art. Thus, in a number of areas the office undertook extensive outreach to assure that it had the best possible information on published business methods.

In determining novelty and obviousness, the examiner consults a variety of databases directed to the subject matter being examined. For applications involving tax strategies, the resources include U.S. patent databases, foreign databases, IRS databases available to the public, and a significant number of commercial databases directed to accounting, finance, and banking. Moreover, the examiner will under USPTO rules request from the applicant information as to which section or sections of the Tax Code are applicable so that those sections may be consulted.

To gain knowledge and expand, and improve our examination of applications relating to tax strategies, the USPTO has partnered with IRS and is currently consulting with the American Bar Association's tax section about possible training and information exchange opportunities. Our existing partnership with the IRS has resulted in training by the IRS for our finance examiners on financial products, wealth transfer, and pensions. The USPTO also provided a modified patent examiner initial training session to selected IRS employees. We are looking at proposed training by the American Bar Association (ABA) that would complement the training that we received and provided to the IRS. We are also discussing follow-up training with the IRS on tax strategy matters. We will continue to conduct business partnership events with Members of the financial services community at large.

Mr. Chairman, the grant of a patent enables a patent owner to exclude for a limited time others from making, using, offering for sale, or selling the invention in the United States. It is not a license to use the invention or a stamp of approval by the Federal government. This principle applies to tax strategy patents as well as to any other patent.We at the USPTO recognize that the patenting of tax planning strategies has raised a number of concerns in Congress, the IRS, and the financial services community. We look forward to working with all interested parties to make sure that these concerns are appropriately addressed within the scope of applicable law. Thank you.

[The prepared statement of Mr. Toupin follows:]

Statement of James Toupin, General Counsel, U.S. Patent and Trademark Office

Introduction

Chairman Camp, Ranking Member McNulty, and Members of the Subcommittee:

Thank you for inviting me to testify today on the patenting of business method inventions, and specifically on those business method patents concerning tax strategies. Patents in this area are a topic of considerable interest and debate and, as has been the case in the past with certain other categories of invention, concerns have been raised about whether business methods involving tax strategies should be patentable. I commend the Subcommittee for holding this hearing.

U.S. Patent System

In order to understand the patentability of business method inventions, I believe it is helpful to first review the underpinnings of the U.S. patent system itself and the role of the United States Patent and Trademark Office (USPTO) in administering this system.

The basis for our patent system is found in Article 1, Section 8, Clause 8 of the Constitution, which provides that Congress shall have the power:

"To promote the progress of science and useful arts, by securing for limited times to . . . inventors the exclusive right to their . . . discoveries."

Thus, in order to promote the disclosure of new inventions, a patentee is given the right, for a limited time, to exclude others from making, using, offering for sale, or selling the invention in the United States.

Following this Constitutional authority, our Founding Fathers designed an extremely flexible patent system based on principles that have proven remarkably adaptable in supporting over 200 years of economic and technological change. The uniformity and flexibility of the patenting standards of novelty, non-obviousness, adequacy of disclosure, and utility—coupled with the incentives patents provide to invent, invest in, and disclose new technology—have allowed millions of new inventions to be developed and commercialized. This has enhanced the quality of life for all Americans and helped fuel our country's transformation from a small, struggling nation to the most powerful economy in the world. Equally as impressive, the patent system has withstood the test of time. This is powerful evidence of the system's effectiveness in simultaneously promoting the innovation and dissemination of new products and processes and the creation of new industries and jobs.

Patentability Criteria and "Business Methods"

In administering the U.S. patent laws, the USPTO takes its direction on what subject matter is patentable from Congress and our reviewing courts. The current Act that details the standards of patentability, the Patent Act of 1952, specifies four basic statutory requirements that must be met to obtain a patent: (1) the claimed invention must define eligible subject matter and have utility; (2) it must be novel; (3) it must not have been obvious to a person having ordinary skill in the art at the time the invention was made; and (4) it must be fully and unambiguously disclosed in the text of the patent application to show that the inventor had possession of the claimed invention upon filing and that the skilled practitioner would be able to practice the claimed invention without undue experimentation.

Before it grants a patent, the USPTO examines each patent application to determine whether it meets these four criteria, as set forth in title 35 of the U.S. Code. With respect to the statutory requirement of eligible subject matter, 35 U.S.C. 101 states that any person who "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 . . ." subject to the conditions and requirements of the law. Thus, the threshold inquiry as to whether subject matter is eligible to receive patent protection is whether an invention is "new and useful" and whether it fits into one of the enumerated categories.

The courts have recognized the breadth of this statute. In the landmark case of *Diamond v. Chakrabarty*, 447 U.S. 303 (1980), the U.S. Supreme Court acknowledged that Congress intended the statutory subject matter under 35 U.S.C. 101 to include "anything under the sun that is made by man." The Supreme Court also noted that there are limits to patentability. Indeed, in *Diamond v. Diehr*, 450 U.S. 175 (1981), the Court explicitly identified three specific areas of subject matter that are excluded from patent protection. These three areas are: (1) laws of nature, (2) natural phenomena and (3) abstract ideas. Thus, an invention directed towards a pure algorithm or manipulation of abstract ideas with no practical application is not patentable.

The broad coverage of the Patent Act helps assure that the patent system is equally available to provide stimulus for innovation in all areas, not just some. The growth and importance of computers have led to a significant increase in investment and development in computer-related processes, particularly with regard to electronic commerce. This has inevitably led to more individuals seeking patent protection in these areas. In response to this increased patent activity, a number of cases arose in the 1990s involving issues of defining the boundaries of patent eligibility. Accordingly, the Court of Appeals for the Federal Circuit rendered a series of decisions following the Supreme Court in *Diehr* and *Chakrabarty* that further defined patentable subject matter. I would like to briefly discuss these cases, which very clearly set forth the standards for patentability according to our patent law.

In the case of *In re Alappat*, 33 F.3d 1526 (Fed. Cir. 1994), the Court of Appeals for the Federal Circuit, sitting en banc, overturned the USPTO and found that inventions that include mathematical formulas or algorithms are not unpatentable if they are practically applied. Thus, the mere presence of an algorithm within an invention does not exclude the entire invention from patentability. The key question to be answered is whether the claimed invention, when looked at "as a whole," is an abstract idea, such as a disembodied mathematical concept, or whether the invention produces a practical application, which achieves a "useful, concrete and tangible result."

Four years after *In re Alappat* came the most well-known case with regard to business methods: *State Street Bank and Trust Co. v. Signature Financial, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998). The *State Street* case involved a patented data processing system that transformed data representing discrete dollar amounts into a final share price momentarily fixed for recording and reporting purposes. The Federal Circuit noted that a process, machine, manufacture, or composition of matter employing a law of nature, natural phenomenon, or abstract idea may be patentable subject matter even though a law of nature, natural phenomenon, or abstract idea would not, by itself, be entitled to such protection. As such, the court held that a machine programmed to transfer data which represents discrete dollar amounts into a final share price through a series of mathematical calculations does, in fact, constitute the practical application of a mathematical algorithm, formula, or calculation because it produced a "useful, concrete and tangible result." The final share price resulting from this process enabled investors and their brokers to make investment decisions for investment and tax advantage purposes.

The significance of *State Street* goes beyond its immediate holding. The Federal Circuit in *State Street* explicitly rejected the notion that a "business method" exception exists in United States patent law, thereby ending any notion that inventions deemed to be business methods, by whatever criteria, would be excluded from patentability on that basis alone. Thus, the *State Street* decision clarifies that an invention deemed to be a "business method" will be treated in the same manner as any other method or process invention. In other words, the patent system is technology neutral and there shall be no disparate treatment for different categories of inventions. This principle was reaffirmed by the CAFC in 1999, where the court remanded the case of *AT&T Corp. v. Excel Communications, Inc.*, 172 F.3d 1352 (Fed. Cir. 1999) to the district court and concluded that had the court applied the proper analysis, the claimed telephone call tracking method fell comfortably within the "broad scope of patentable subject matter under § 101."

Business Method Filing Information

While *State Street* did not change United States law and practice, it did create a new awareness that business method claims could be patented. For example, in fiscal year 1998 there were fewer than 1,500 filings in the U.S. classification area 705, which includes much of what is commonly known as computer-implemented "business method" inventions. By contrast, there were approximately 9,000 filings in fiscal year 2001; approximately 7,400 filings in fiscal year 2002; approximately 7,700 filings in fiscal year 2003; approximately 8,200 filings in fiscal year 2004; and approximately 8,200 filings again in fiscal year 2005.

The change in the understanding of the law that led to this expansion of business method patent applications created challenges for the USPTO and the business community. In particular, because business methods had been commonly not regarded as eligible for patenting, examiners did not have available to them an extensive database of prior art in the form of existing patents. Accordingly, in a number of business areas, the Office undertook extensive outreach to the concerned public to assure its access to the best possible information on published business methods. In the initial period after the *State Street* decision, allowance rates for business method patent applications were relatively high, but with the Office's and the public's increasing focus on this art, the allowance rate has fallen.

As of mid-year, fiscal year 2006, the allowance rate for business method applications was approximately 20%, which is lower than the overall USPTO patent allowance rate of approximately 54% at mid-year.

Today, the computer-implemented "business method" area includes business practices in many fields such as health care management, insurance and insurance processing, reservation and booking systems, financial market analyses, point of sale systems, tax processing, inventory management, accounting and financial management.

In fiscal year 2005 we hired 36 patent examiners in the business method area for a total of 132 examiners. Our goal for fiscal year 2006 is to have a total of 160 examiners in this area by the end of the year.

Recently, subclass 36T in Class 705 has been established and dedicated to tax strategies.

We have identified 41 issued patents related to tax strategy. Further, 61 published applications, not yet examined, relate to tax strategy.

The average pendency to first office action in the tax strategy area is approximately 44 months and the average pendency to issue or abandonment is approximately 50 months. Currently, applications in this area filed in May 2001 are receiving their first office action.

Issurance of Patents

As discussed, the USPTO is charged with examining patents following certain patentability criteria as enacted by Congress and interpreted by the courts. In examining patent applications, the Court of Appeals for the Federal Circuit has recognized that the utility requirement under 35 U.S.C. 101 is "not high." *Juicy Whip, Inc. v. Orange Bang, Inc.*, 185 F.3d 1364, 1366 (Fed. Cir. 1999). Importantly, the Federal Circuit has stated that there is no clear provision that allows the USPTO to reject an invention solely on the grounds that the invention may be against public policy, specifically:

The requirement of "utility" in patent law is not a directive to the Patent and Trademark Office or the courts to serve as arbiters of deceptive trade practices. Other agencies, such as the Federal Trade Commission and the Food and Drug Administration, are assigned the task of protecting consumers from fraud and deception in the sale of food products. *Cf. In re Watson*, 517 F.2d 465, 474–76, 186 USPQ 11, 19 (CCPA 1975) (stating that it is not the province of the Patent Office to determine, under section 101, whether drugs are safe). As the Supreme Court put the point more generally, "Congress never intended that the patent laws should displace the police powers of the States, meaning by that term those powers by which the health, good order, peace and general welfare of the community are promoted." *Webber v. Virginia*, 103 U.S. (13 Otto) 344, 347–48, 26 L.Ed. 565 (1880). Of course, Congress is free to declare particular types of inventions unpatentable for a variety of reasons, including deceptiveness. *Cf.* 42 U.S.C. § 2181(a) (exempting from patent protection inventions useful solely in connection with special nuclear material or atomic weapons). Until such time as Congress does so, however, we find no basis in section 101 to hold that inventions can be ruled unpatentable for lack of utility simply because they have the capacity to fool some members of the public. *Juicy Whip, Inc.*, 185 F.3d at 1367–68.

The USPTO has issued patents to inventions that may arguably be illegal at least in certain jurisdictions, and may be considered to be immoral or offensive by some. For instance, a patent to a method of producing alcoholic liquids from which certain toxic chemicals had been removed (1,785,447 issued December 16, 1930) issued during Prohibition, even though the method could be used for then-unlawful purposes. Other examples include a radar detector (7,023,374 issued April 4, 2006) the use of which is unlawful in some jurisdictions; a device for use in cock fights (6,928,960 issued August 16, 2005); a gambling device (6,540,609 issued April 1, 2003); a method of euthanizing a mammal (5,290,775 issued March 1, 1994); and a method of preparing ricin toxin useful for toxicological warfare (3,060,165 issued October 23, 1962). In issuing these patents, the USPTO has endeavored to carry out its mission to grant patents as allowed by law, and to refrain from making policy decisions not within its legal authority. To cite the USPTO Board of Patent Appeals and Interferences (BPAI) in the context of an application for a gambling device, "this Office should not be the agency which seeks to enforce a standard of morality." *Ex parte Murphy ,* 200 USPQ 801 (Bd. Pat. App. & Interf. 1977).

Hence, a wide range of products, services and processes may be patentable, but their sale or use is subject to applicable federal, state and local rules and regulations. Accordingly, while the USPTO may grant a patent on a tax strategy, that patented strategy should not be practiced or marketed unless it complies with applicable law, rules and regulations administered by the Internal Revenue Service.

Examination Process of Tax Strategy Patents

The examiner who is assigned a patent application involving a tax strategy examines that application using the same statutory requirements for patentability under 35 USC 101 (useful), 112 (disclosure requirements), 102 (novel), and 103 (non-obvious) as that examiner would use in examining any other technology. In determining novelty and obviousness, the examiner consults a variety of databases directed to the subject matter being examined to find the best prior art. For applications involving tax strategies, the resources include U.S. Patent databases, foreign databases, IRS databases available to the public, and a significant number of commercial databases directed to accounting, finance, and banking. The examiner also has a library dedicated to finance and accounting subject matter.

Moreover, if in the course of examination, the examiner identifies a tax strategy claimed or disclosed, the examiner will, under Rule 37 CFR 1.105, request from the applicant information as to which section or sections of the tax code are applicable so that those sections may be consulted.

Importantly, in order to gain knowledge and improve our examination of applications relating to tax strategies, the USPTO is working on developing two significant relationships. Specifically, the USPTO has partnered with the IRS and is currently developing a partnership with the American Bar Association's Section of Taxation (ABA) to pursue training and information exchange opportunities. The partnership with the IRS has resulted in training by the IRS for our finance examiners on financial products, wealth transfer, and pensions. The USPTO also provided a modified Patent Examiner Initial Training (PEIT) for non-examiners for selected IRS employees. Topics included: (a) statutory requirements of a patent application; (b) concept of prior art under 35 USC 102 and 103; (c) patentability under 35 USC 102 and 103; (d) identifying and searching relevant databases; and (e) and post-grant review procedures by the USPTO for issued patents. We are looking at proposed training by the ABA that would complement the training received by and provided to the IRS. We are also discussing follow-up training with the IRS on tax strategy issues.

Thus, as it has in other areas of business method practice, the USPTO is actively seeking assistance to assure that it has the best possible information and understanding of the tax strategy area. While the USPTO does not employ outside sources or "experts" as consultants in the examination of specific patent applications directed to tax strategies, we are developing the expertise necessary to examine these types of applications. Moreover, the publication of applications now allows participation by third parties in the examination process.

Publication of Applications

Approximately 90% of patent applications are published 18 months after the earliest effective filing date, although an applicant may request that the application not be published if the invention has not been and will not be the subject of an application filed in a foreign country that requires publication 18 months after filing. Following publication, the application for patent is no longer held in confidence by the USPTO and any member of the public may gain access through our website to the entire file history of the application.

Third-Party Participation During the Examination Process

The Patent Act places limitations on the USPTO's ability to entertain third-party submissions in examining patent applications. In particular, 35 USC 122(c) requires the USPTO to ensure that no protest or other form of pre-issuance opposition may be initiated after an application is published except on consent of the applicant. Accordingly, under 37 CFR 1.291 and 1.99, although a third party may file a protest against a pending application before the date it is published or allowed, once an application is published or a notice of allowance mailed, a third-party may only submit prior art, without comment.

After the patent is granted, there are other procedures by which a third party may challenge an issued patent.

USPTO Review and Thrid-Party Participation After the Patent Issues

Post-grant review of patent claims takes place before the USPTO under certain circumstances, including when: (1) a patentee files an application to reissue a patent to correct at least one error in the patent, (2) an applicant and a patentee claim the same invention and an interference is declared between the patentee and the applicant, and the applicant seeks judgment based on unpatentability of patent claims, and (3) a patent owner or third party requests the reexamination of a patent.

Congress has incrementally added to the range of proceedings within the USPTO's jurisdiction under which third parties can invoke Office review of issued patents. *Ex parte* reexamination, enacted in 1980, permits a third party to petition for reexamination of the patent. In 1984, section 135 of the Patent Act was amended to allow issues of patentability, as well as priority, to be included in interference proceedings. As part of the American Inventors Protection Act of 1999 (AIPA), Congress created *inter partes* reexamination, whereby the third party could participate in the reexamination proceeding and appeal to the USPTO's administrative Board of Patent Appeals and Interferences.The AIPA's inter partes reexamination practice was expanded in 2002 to afford third parties the right to appeal to the CAFC.

The most common third-party participation is through reexamination proceedings. An important check on patent quality relates to the occasions when prior art (*i.e.*, printed publications and patents) is brought to the USPTO's attention that may raise a substantial new question of patentability. Often, this evidence may be identified and submitted by a third party, such as a commercial rival that wishes to challenge the patent's validity. Congress established this administrative procedure for the USPTO to take a second look at an issued patent and consider questions of validity during the life of the patent.

However, although Congress has increased, through these amendments, the USPTO's role in helping guarantee the efficacy of the patent system after patent issuance, none of these procedures alone, or collectively, has proven sufficient to optimize the USPTO's post-grant capability.

Accordingly, the USPTO recommended a new post-grant review procedure in its 21st Century Strategic Plan. A version of such a procedure is currently under consideration in Congress. It would serve as a quicker, lower cost alternative to expensive litigation in reviewing patent validity questions. Such a procedure would complement rather than displace ongoing quality-focused initiatives at USPTO, which include measures to address the hiring, training, certification and retention of an adequate number of examiners. The USPTO will work with Congress and other stakeholders in developing a post-grant review procedure that effectively serves the interests of the patent community.

Conclusion

We recognize that the patentability of tax planning strategies has raised a number of concerns in Congress, the Internal Revenue Service and the financial services community. We look forward to working with all interested parties to make sure those concerns are appropriately addressed in a manner consistent with applicable law, rules and procedures.

Thank you.

Chairman CAMP. Thank you very much. Now the Honorable Mark Everson. You have 5 minutes and your statement also will be part of the record.

STATEMENT OF THE HONORABLE MARK EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. EVERSON. Thank you. Chairman Camp, Ms. Tubbs Jones, Congressmen, I am pleased to be before the Subcommittee today to discuss this important issue of patenting tax products. At the IRS, we constantly work to improve our service to taxpayers. By "service," we mean enabling taxpayers to understand the tax law and helping them to meet their obligations under the Code. Patented products can help taxpayers plan for and pay their taxes. Patents can encourage the invention of software to make paying taxes easier. In this regard, patented or trademark products can ease the compliance burden on taxpayers and lessen the enforcement load for the IRS. That having been said, taxpayers should understand what a tax patent really is, or rather what it is not. A patent is not a government seal of approval for a particular product. A patent simply protects the invention against infringement by others. In the area of tax structures or strategy, a patent has no bearing on whether a tax product is legitimate or not. That is for the IRS and the courts to determine.

In fact, over time, proliferation of tax patents may create enforcement problems. We have been concerned that some taxpayers may attempt to patent abusive tax schemes. Fortunately, thus far, we have found little evidence of this, but we remain watchful. The rising use of patents for tax strategies and structures will also place a burden on tax professionals. A lawyer may need to do an extensive search of the United States Patent and Trademark Office databases to determine whether advice to a client, such as tax planning strategies, could be a patent infringement. This can be a time-consuming and complex process. Without such a search, a practitioner could expose himself or herself, or possibly even his or her client, to potential liability for royalties or infringement litigation.

Since 2004, the IRS has worked with the Patent and Trademark Office to make the tax patent system more transparent and make information about tax patents more accessible. A classification system has been created to help identify whether a patent application includes a tax strategy. We have encouraged practitioners, such as the ABA or the AICPA, to contribute their expertise to this effort. In sum, we have strengthened our relationship with the Patent and Trademark Office, and we have increased awareness of the potential for misbehavior in the tax patent area.

Before closing, let me turn briefly to two additional subject. First, the President's 2007 budget request for the IRS. While I appreciate the difficult choices facing Congress, overall I am very disappointed by the funding level established by the House bill, which falls over $100 million short of the President's request. The House bill would damage our efforts to attack the tax gap and reduce the Federal deficit. The bill would even result in personnel reductions within the IRS. Second, I also urge your support of several legislative proposals to strengthen tax administration that accompany the budget.

The most important proposal would mandate reporting to the IRS of gross receipts by credit card issuers for their business customers. We know that where there is third party reporting to the IRS, compliance rates are high because income is reported accurately by the taxpayer. I urge you to review the President's proposals and actively support them. Thank you.

[The prepared statement of Mr. Everson follows:]

Statement of The Honorable Mark Everson, Commissioner, Internal Revenue Service

Introduction

Chairman Camp, Ranking Member McNulty and members of the Subcommittee, I am happy to be here this morning to address the issue of patenting tax strategies including potential tax shelters. This is an issue with which we have become much more familiar in recent years and have worked with the United States Patent and Trademark Office (USPTO) as more patents have been granted for tax products.

Framing the Issues

As the Subcommittee focuses on the larger issue of tax patent strategies (TPSs), I think it is important to properly frame the issue and understand IRS' role or lack thereof in the patent process.

First, we need to draw a distinction between the granting of patents to tax products or strategies that are in compliance with the tax laws, and to abusive tax shelters or other products that may not be. On the one hand, the ability to obtain a patent could encourage the development of products to help people comply with the tax law, similar to other protections of commercial interests such as trademarks and copyrights.

Our operating philosophy at the IRS is that service plus enforcement equals compliance. From that perspective, tax 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. For example, a patent for a novel type of tax computation software that makes filing easier could benefit many taxpayers. This category of patents is potentially helpful to our mission by encouraging needed research and innovation by the private sector.

Second, we recognize that there are substantial policy issues as to whether or not business methods involving tax strategies or products should be granted protection by the government. Granting patent protection to such strategies could limit the use of that particular tax strategy by other taxpayers and have a negative impact on their ability to comply with the tax law.

While the policy issues are significant, many are outside IRS' jurisdiction and field of expertise. Importantly, the granting of a patent on a tax strategy provides protection to the patent holder against infringement by other parties, but has no bearing on its legitimacy or illegitimacy under the tax laws, which remain under the jurisdiction of the IRS.

Unlike a private letter ruling, a pre-filing agreement, or an advance pricing agreement, a patent carries with it no assurance whatsoever that the patented process, transaction or structure will pass IRS muster. We are concerned, however, that taxpayers may be confused about this and may view a patent as a government seal of approval of all aspects to which the patent pertains, including the tax aspects.

We understand that some developers of tax-related patents may advertise and promote their "patented" concepts to the general public. We are currently considering ways to reduce the risk of taxpayers mistakenly believing that the issuance of a patent is indicative that the IRS has approved the particular technique being marketed.

Just so there is no misunderstanding today on this point, let me be clear. The grant of a patent for a tax strategy has absolutely no impact on IRS' determination of the effectiveness or the legitimacy of the strategy under tax law. The IRS will issue a policy statement that will make this clear to all taxpayers.

Third, we recognize that taxpayers may attempt to patent abusive tax schemes. As I will discuss later, however, we have not seen such an abuse in our review of existing tax patents.

Finally, patented tax strategies place an increased burden on practitioners who, while simply developing good gift, estate or business planning strategies for their clients, would be obligated to conduct "due diligence" searches for existing patents on such strategies.

I will talk later about the patent searches that the IRS has done from the USPTO public data base. That experience has taught us that patent searches can be cumbersome and time-consuming. This burden is accentuated if a patent has been granted for a commonly used "tried and true" technique within a field. In these cases, a practitioner who wishes to use a standard planning technique could expose himself and his client to potential liability for royalties or infringement litigation.

As you can see, tax-related business process patents raise issues for the IRS. They raise even more complex policy issues for others.

I would now like to discuss what we have done and are doing to monitor tax patents as well as how we are working with the USPTO. The point of this work has been three-fold: first, to use the USPTO databases as another potential source of information about the marketing of abusive tax schemes; second, to detect whether patents are being used as a way to avoid other characteristics the IRS has identified as indicating potentially abusive transactions; and third, to assist the USPTO in carrying out its mission.

Patent Reviews

IRS's principal interest in patented tax strategies is in determining whether promoters are patenting abusive tax avoidance transactions (ATATs).

To that end, in 2004 and 2005 we performed two searches of the more than 6.5 million patents in the USPTO data base. The first search, conducted in November 2004 was designed to identify patents and public applications of known tax shelter strategies, specifically of IRS transactions identified as "listed" transactions in Notices 2004–67, which is the list of thirty transactions that have been determined by the Internal Revenue Service to be "listed transactions" as of October 12, 2004, and Notice 2005–13 which listed another transaction on February 28, 2005. That search, which was updated in November 2005 and again in June 2006, found no evidence of patents or public patent applications embodying any of the abusive tax shelters or listed transactions.

A second type of search was conducted in July 2005 and is updated periodically. The goal of this search was to measure the occurrence and type of business patents that might involve tax strategies. The initial search just asked for patents that included the word "tax" in applications and granted patents in all classifications. Of the 6.8 million patents in the USPTO data base we had fewer than 300 "hits". A further analysis showed that approximately 100 of these dealt with "Business methods" and the majority of those appeared to be software models for computing tax impact or effect, and not tax strategies.

We were left with 14 patents and applications primarily in the areas of employee compensation, wealth transfer, and financial products. Upon initial examination, none of the 14 patents were found to be abusive tax avoidance transactions. We have subsequently completed our review of 12 of the 14, one of which was allowed by the applicant to expire for non-payment of fees. While we do not consider them to be ATATs, we are continuing to review two of the transactions to fully satisfy ourselves that they do not present compliance risk requiring follow up action on our part. Ultimately, we often need to see a real world example of how the transaction is carried out before we can be confident that the transaction is not abusive

Based on this analysis, we thus far have not seen the use of the patents in developing or marketing aggressive or abusive tax strategies, but we continue to monitor on a quarterly basis the USPTO tax patent data base.

Working with the USPTO

Since 2004, we have been working with the USPTO to help it address concerns about patents granted. Specifically, we formed a task force with members from both agencies to establish the scope of our effort. Last summer, we conducted a cross-Agency workshop which encompassed topics requested by the USPTO. This was an awareness workshop and was similar to what industries have historically done with the USPTO to keep them abreast of the latest sources of information, trends in practice, and the like. Our goal was to assist the USPTO in developing the resources to determine "prior art" in the area of tax strategies and structures.

The prior art doctrine is a cornerstone in the patent application examination process. Under this doctrine, a patent application should be rejected if the subject matter is neither new nor original.

IRS does not consult with the USPTO in the review of "prior art". Our contribution to this process would be tangential to our core mission. Moreover, if the IRS were to have a special or official role in evaluating the novelty and non-obviousness of a patent, this might be mistaken for IRS approval of the strategies or structures being patented.

There are also significant confidentiality restrictions on both agencies that could hinder a cooperative effort in the review or prior art. As a result, USPTO must instead rely on input from the practitioner and other stakeholder communities to develop a reliable profile of what qualifies as prior art.

Practitioners are generally the creators of business methods and tax strategies. As they have raised concerns, the IRS has encouraged practitioner organizations, such as the American Bar Association and the American Institute of Certified Public Accountants, to play an active role in supplying the USPTO with useful information on business methods for consideration as prior art.

We have also offered USPTO ideas on how to ferret out a tax strategy during a patent examination. USPTO has also created a classification category dedicated to TPSs. This is a sub-classification (36T) of Business Method Patents dedicated to tax strategies. In March 2006, we began quarterly monitoring of this TPS sub-classification.

In addition, we consulted with the USTPO in the development of a protocol to allow patent examiners, once it is determined that the patent has a tax aspect, to request that patent applicants reveal specific Internal Revenue Code regulations and procedures affected by a patent application.

These steps should not only make it easier for the IRS to track patents of tax strategies and structures, but it should help tax professionals identify these patents for whatever purpose.

Conclusions

In conclusion, Mr. Chairman, the cooperative efforts between the USPTO and the IRS have resulted in significant strides in monitoring and reviewing tax strategy patents. Transparency of these types of patents has increased; USPTO examiners have a broader base of knowledge on which to assess patent applications; and the IRS has benefited by gaining an understanding of the patent process and the rights a patent bestows on its owner. This latter point is a key factor in valuation issues addressed by IRS examiners such as donations made under prior law, off-shore transfers, and arm's length consideration for patents.

We recognize that some patents or trademarks actually benefit both taxpayers and the IRS in that they protect techniques that ease the compliance burden on taxpayers and may lessen the enforcement load of the IRS. In addition, while the IRS has worked to gauge the impact of patented tax strategies and structures on compliance and administration, we have found little evidence to suggest that tax shelters or aggressive tax avoidance transactions are being patented. But we recognize that the potential for significant problems could exist.

While patenting tax strategies and structures make the transactions more transparent, there are several negative by-products to this process. First, we believe that the public may be largely unaware about both the rights that a patent owner enjoys and the fact that a patent does not guarantee that the transaction has the desired tax consequences. Let me repeat what I said earlier: a patent for a particular technique carries no weight with the IRS in assessing compliance with tax laws and regulations.

Second, we believe that the trend toward increased patents of tax strategies and structures places an increasing burden on tax professionals. They must do an extensive search of the USPTO data base to determine if a particular strategy is protected.

We will continue to work with the USPTO in targeted areas. We also strongly encourage the practitioner community to take an active role in assisting the USPTO in addressing developing issues with this evolving area of patent law.

Thank you again, Mr. Chairman for the opportunity to be here and I will be happy to respond to any questions that you may have.

Chairman CAMP. Thank you very much. Thank you both. Now we will have a period of questioning. Mr. Toupin, is tax law really appropriate for patents?

Mr. TOUPIN. Well, the courts have interpreted the broad language of the Patent Act that the Act is designed to provide innovative stimulus equally across the board and to all forms of innovation that meet the broad language of the statute. The courts have held that the question of whether or not a particular invention may be against some form of public policy or may be contrary to the regulatory scheme of another agency is not for the patent office to decide. That is rather a question for the other regime. Our job is simply to see whether or not it meets the criteria for patent ability.

Chairman CAMP. Mr. Everson, given that much of tax advice is done confidentially, is tax law really appropriate for the patent process, and, particularly, asking people to pay a royalty to comply with the law is what a patent on a particular method might do, do you have any thoughts on that?

Mr. EVERSON. There are a couple of points in there, sir, I would suggest to you that one of the real problems is the complexity of the Code. That is a huge problem. The President has called for simplification. I know that the Congress and everybody else want to get that done, it is just hard to do. The complexity of the Code creates real reasons for people to search for ways to help folks comply. That having been said, when you get to the question of seeking to reduce the tax, the question is when do you approach that line where you get to non-compliance, if you will. My concerns here are with the confidentiality of the return, so it is very hard, I believe, for the patent folks to understand what is the common practice out there. They don't have an ability to look in and see what the return is. That is confidential between the practitioner and the taxpayer and the service. So, I am not sure that it is easy to get an understanding of what is known or prior art—these are the terms that my colleague is more familiar with than I am. So, I think we are applying a set of incentives to a different model here, and it is very, very hard to do that effectively.

Chairman CAMP. I realize that the Patent Office, if you are patenting a better mousetrap, that doesn't necessarily say that it is going to be effective, just as they don't say that this necessarily means you are complying with the law. It seems when it comes to tax matters, that it is not a golden seal of approval, as you were sort of mentioning. How is the average citizen supposed to know that because most people are going to say this is the government. If I am reading an advertisement for a particular method and it has been patented, I am going to think the government has looked at it. We realize that there is not necessarily a commitment that that is a legal strategy or even tax compliance at all but how is the average person supposed to figure this out?

Mr. TOUPIN. Well, I think there are two answers to that question. One is that an advisor, relying on the patent, will have an ethical obligation to accurately advise the client as to the significance of a patent. The second is, and I know that the Internal Revenue Service is working on this, to develop outreach that would explain the significance of these patents.

Chairman CAMP. Well, I appreciate both of you being here. At this time, I will recognize the gentle woman from Ohio for inquiry.

Ms. TUBBS JONES. Thank you, Mr. Chairman. In my prior life, I was the Cuyahoga County prosecutor doing both civil and criminal work, and I was a judge for 10 years, eight years in general jurisdiction. I am sitting here thinking, saying what if this came into my courtroom, what would I have done with this particular situation? I am concerned that we would develop a patent for tax advice, and I have nothing against tax attorneys and I want them to make all the money in the world, not all the money, we want to make some too.

Mr. TOUPIN. The IRS might want to make some.

Ms. TUBBS JONES. Of course, you will get your piece, you always do sooner or later anyway. That would be available to some people and not to all people. In my mind, and I am not a patent expert, I don't know if our laws contemplated the ability of some to access advantages in the Tax Code and others to not access advantage. That being said, assume a patent application met all the patent law criteria, would or could the Patent Office approve a patent for an illegal tax shelter?

Mr. TOUPIN. Can I address the first part and then the second part?

Ms. TUBBS JONES. No, no. Yes, sure you can.

Mr. TOUPIN. I think that there is a bit of a confusion about what access means in this regard. An alternative strategy to patenting is to keep strategies as trade secrets. Now those trade secrets may be known to some advisers and not other advisers. The existence of a patent—the trade-off for the existence of a patent is to make it known to the world. Our database is an absolutely terrific body of knowledge for the public to access. So, in terms of whether a patent would make a strategy more available or less available, it is a bit of a trade-off between whether the cost of the license that might be requested outweighs the cost of each tax adviser inventing the same strategy for each client.

The second issue is if Members of the tax advice community want to establish that certain strategies are well known, they will begin to publish the information about those strategies that they may not have published previously. So, the net effect—it is possible that the net effect of patenting is to make strategies more readily available to the public rather than less.

Ms. TUBBS JONES. I see somebody in the audience shaking their head. I won't identify who it is but go ahead.

Mr. EVERSON. Can I jump in for a second before we get to that second piece, is that okay?

Ms. TUBBS JONES. No, go ahead. I could order the head of the IRS around. Let me try this one more time. No, I am kidding, go ahead.

Mr. EVERSON. I read the paper that the Joint Committee staff put together, which was excellent. One of my favorite lines is on page 25. It says, "Regardless of whether tax strategies are socially beneficial, there is no need for patent protection"—some people are saying this—"in order to encourage their development as they seem able to proliferate without such protection." I think that is absolutely true. The testimony that you submitted talks about the Constitution talking about patents and incentives and that sort of thing. In our country, you go back to the Boston Tea Party, people have been trying to lower their taxes for a long time, and I think there is plenty of activity here, so I would question this balance as to incentives and protections in this instance.

Ms. TUBBS JONES. The second question.

Mr. TOUPIN. The patent examiners are required to examine whether or not the patent application—the claimed invention is useful. In some of these applications that may or may not require examination of whether or not it would in fact achieve the advantage claimed. In that context, they are doing a scrutiny that is not different from what they do when they are looking at a claim to a mechanical invention. In that context, they will look to see whether one of ordinary skill in the art would believe that the thing would work as claimed. They do that on the basis of the information they have. That judgment can be challenged in a subsequent infringement action or declaratory judgment action if it proves to be incorrect.

Ms. TUBBS JONES. Well, your answer is yes or no?

Mr. TOUPIN. They will look to see—if it is claim to a specific tax advantage, and that is the only utility claim, which I think is a rare—they will look to see whether on the basis of the facts they have one of ordinary skill in the art would believe that it would be operable as claimed. So, would it work? They will look at that issue.

Ms. TUBBS JONES. So, yes?

Mr. TOUPIN. Yes.

Ms. TUBBS JONES. Thanks, Mr. Chairman.

Chairman CAMP. Thank you. The gentleman from Georgia may inquire.

Mr. LINDER. Mr. Toupin, are there any other business practices that have been patented?

Mr. TOUPIN. Yes.

Mr. LINDER. Along the same lines as these?

Mr. TOUPIN. Well, we recently put to the Office of Personnel Management (OPM) a request to expand the classification for patent examiners and that included incentive programs, such as—the subject matters that we were looking at, incentive motions, such as coupons, operation research, finance, banking and accounting, electronic shopping, health care, insurance, inventory controls, business processing. So, there is a wide variety.

Mr. LINDER. This is mostly software?

Mr. TOUPIN. Oftentimes they will include an information technology (IT) application.

Mr. LINDER. How many of these tax patents have been issued so far?

Mr. TOUPIN. About 40.

Mr. LINDER. How many are pending?

Mr. TOUPIN. The published applications are around 60 that are pending.

Mr. LINDER. Do you expect this trend to continue?

Mr. TOUPIN. Well, the trend is that it is a very low level of filings. It is very low in relation to business method patents as a whole. It is certainly very low in relationship to the 400,000 applications we get a year. The grant rate for business method applications has declined over the years since State Street Bank. So, my expectation is that the leveling off of business method patents as a whole, which we have experienced in the recent years, probably is likely to continue.

Mr. LINDER. Does your office make any assessments as to whether this procedure or this business practice deals with aggressive deducting?

Mr. TOUPIN. No.

Mr. LINDER. Have you looked at these, Mr. Commissioner, these 40 patents?

Mr. EVERSON. Yes, sir. I guess we did some searches of the database, and we got it down to where we looked at 100 patents. Some of them mentioned tax and, they weren't really in the end tax products. We got down to about a dozen or more that we were potentially concerned with. Thus far, as my testimony indicates, we haven't seen any real problems. Now, let me say this though, this is very important. What we often find with shelters and abusive transactions in general is that somebody will structure a transaction and it will be okay. Then a month later, there will be another transaction that moves just a tiny bit. There is a bell or a whistle that is attached. Then over a very long period of time, you have something that has approached and then crossed the line. My fear or concern in this area is the same thing—you could conceivably patent something that would work and then very quickly it could be modified, and it would just take a long time through litigation and everything else to get it all settled out as to whether the product had moved away from a legitimate patent. In the interim, there could be a lot of damage to the tax system.

Mr. LINDER. Well, with 60,000 pages of regulations and complexities, I think there are probably dozens and dozens of ways to legally abuse the system. I think there are some people—there is a huge article about a lawyer in New York City who is very smart and he understands the Tax Code as well as anyone, and he finds ways to abuse it legally. Even though I have a modest tax reform bill that would take us back to the Boston Tea Party and solve your complexity at the same time. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. Yes?

Ms. TUBBS JONES. Gentlemen, I am going to leave, as I said earlier, but I have some questions I would like to submit for the record to get some written responses, if you don't mind. One of those is "Is tax advice legal advice and can legal advice be patented?" That is my kind of curious thinking.

Chairman CAMP. Yes, and without objection, and if you could respond in writing to those questions. The gentle woman from Pennsylvania may inquire.

Ms. HART. Thank you, Mr. Chairman. I appreciate the opportunity to be here, and I will certainly review your testimony in greater detail. Sorry, I am just walking in. We had a little discussion about some of these issues yesterday and they really kind of throw more questions open when you start looking at this issue. I have maybe the good fortune or bad fortune of having served on the Intellectual Property Subcommittee and Judiciary before I came to Ways and Means, so, now, it is even more—have a bizarre view. So, I guess I am most interested in your reflection on what the IRS views as listed transactions or tax shelters.

If there are patents issued for these particular products or processes or procedures, I guess in some cases they are, how does the IRS pursue compliance? Is there any point at which there is some kind of deference given to a procedure because it is patented or does it go the other way around with the PTO regarding the respect for something that may be or a lack of respect for something that may be opposed by the IRS, back and forth?

Mr. EVERSON. As I indicated in the testimony, the actions that are taken by the Patent Office have no bearing on how we come down on a particular transaction. Now, you mentioned listed transactions, those are transactions that we list as potentially abusive and subject to scrutiny, special scrutiny by our examiners. Someone suggested that what we ought to do is make people report whether they are using a patented transaction. I would not endorse that at this time for two reasons. First, as I indicated, thus far we haven't seen substantive problems here. We have theoretical concerns about what could happen, but we haven't seen substantive problems. Second, we set up a screen, criteria for what people need to disclose, and it would be unfair to tar all patents, as long as that is the law, with having them be disclosed in the tax preparation process since there is no evidence at this stage that they are a particular problem.

Ms. HART. Regarding the process back and forth between the agencies, what would trigger a consultation with the IRS and the PTO regarding these issues? Is there something that would sort of throw up the red flag and actually cause that consultation to occur, I guess application for a patent?

Mr. TOUPIN. Right, as we discussed earlier, there is consultation on the overall issue of mutual training. With respect to specific consultation on a particular application, the PTO is constrained by the laws that are applicable to it. It is required to keep applications confidential. Upon their publication, it is required not to provide for opposition proceedings. So, it is difficult at best for the agency to reach out and entertain objection or seek consultation on that point.

Now the Members of the public can submit prior art currently for 2 months after an application is published and the office is now proposing to extend that to 6 months without comment to avoid the statutory prohibition on oppositions. That probably doesn't create the opportunity for the kind of consultation with the IRS that you are referring to.

Ms. HART. Yes?

Mr. EVERSON. I would be very reluctant to have the IRS inserted in an actual approval process. The point being that we have procedures in place where taxpayers come to us and they get private letter rulings, advance pricing agreements based on certain factual circumstances. That is the only time when we step forward and we look at things in advance. Were we to go down this corridor of working on some applications sometimes or even all applications, you would be giving broad pre-approval to transactions that had not yet taken place, and I think to do that would really change the way everything works in a way that we would have to carefully consider before we would do that.

Ms. HART. If the Chairman will indulge just one quick follow-up.

Chairman CAMP. Yes.

Ms. HART. I appreciate that. So, has there not then been a case to this day where—or has there been a case to this day where a patent was actually granted and then the IRS came back and said this is contrary to the Code?

Mr. EVERSON. We are just getting into the examination stream on some of the issues. As my colleague indicated, this has all happened since 1998, I guess when this was started. Then you get the application of the use of the patent itself. Then years down the road, returns come under audit. So, it is too early to say. What I had indicated before is we have studied the dozen or so patents that we thought are potentially of concern, and we haven't seen a theoretical problem with them. I would add, though, that in several instances, if just modified slightly, some of those patented transactions could cause real problems. So, again, you have to get down, do the actual audit, and then make your judgment.

Ms. HART. Thank you. I thank you, Mr. Chairman.

Chairman CAMP. Thank you. I understand your testimony, Commissioner, that there is no formal process between IRS and the Patent Office to examine these business method patents. So, how are these brought to your attention, just informally looking through the website?

Mr. EVERSON. I think what the Patent office has done is now set a distinct category for these, which makes it a lot easier for us to find them and for all interested parties. So, we are sort of in the same boat as everybody else. Then, as was indicated earlier, we are sharing—as we share with the Patent Office emerging concerns on our end and back and forth. So, I think we have a good discussion of what is emerging in terms of the use of these, but that doesn't tie in in terms of the specific time line as to a particular structured transaction or strategy.

Chairman CAMP. Well, the follow-up to that is then if you don't readily identify known practices, and then as applications come in and a patent is issued. Would the burden of challenging that patent fall on the taxpayers who employ this strategy? Whose burden is it? This is part of what I think we are trying to get at?

Mr. TOUPIN. Well, there are two elements. First, after a patent issues, there is a current process for re-examination of a patent. A Member of the public, or even the patentee, believes there is new prior art or a new issue of patentability involving a prior patent or printed publication that should be brought to the Patent Office's attention. The Patent Office has also favored legislation that would involve a more broad-scale post-grant review of patents, which would probably provide a better opportunity for those who might claim that there was a prior public use but not necessarily a patent or printed publication about it. Apart from that, the burden would be on potential users of the patented method through district court proceedings.

Chairman CAMP. It seems as though this is a growing area?

Mr. TOUPIN. Well, it is hard to know whether 41 issued patents since 1998, what the trend is.

Chairman CAMP. What I see that in your testimony you are increasing the number of patent examiners in the business method area from 130 examiners to 160 in a year.

Mr. TOUPIN. In the area of business method patents at large, yes. We are now getting 8,500 of those a year, applications. We currently have 60-odd published applications with respect to this particular subject matter.

Chairman CAMP. Again, realizing the tax method is a smaller part of that growing area, it seems to me that you don't have to purchase some of these other products, it is a choice. Every American has to comply with the U.S. Tax Code which does make—again, kind of going back to my original question, is really tax law appropriate for patenting given that there is an obligation and a legal requirement that you must comply with the tax laws. Then to require Americans to pay a royalty to then do that in the best possible way seems to me a problem. I guess I am more concerned—I realize you don't want to have a formal process between the IRS and the Patent Office but how then do you coordinate this area because it clearly is—there is an overlap here.

Mr. EVERSON. I think it is a serious problem because there is not the transparency. Tax returns are confidential. The advice that is given by a professional is confidential. So, there is not the visibility of a television set or a drug product that is taken out on the market where you say we have got a product that does "X" and it says "patent pending" or whatever it says down on the jar and then it is held up to a certain scrutiny. That is not what takes place here. So, I do find it—I am sure it is a real challenge for people who are trying to assess the patent application to get to this novel or known standard for just that reason.

Mr. TOUPIN. The other answer though is that the IRS and the PTO over the last year to two have begun an active consultation process in terms of mutual training. The advantage of patents is that they are published and they can be known about. As knowledge of those expands over time, I am sure that, though on an interagency exchange basis that is not directed to specific applications, that exchange will become better and better educated as we deal with more of these.

Chairman CAMP. Is there any other kind of legal protection that might work better than a patent for these tax business methods that either of you might comment on? It seems there are some drawbacks to the patent process. First of all, the length of time of getting it. It looked like 44 months I think in the materials I saw, I don't know if that is accurate.

Mr. TOUPIN. No, we are——

Chairman CAMP. Doing better than that?

Mr. TOUPIN. It is very long in many business method areas. We are hiring up to try to deal with that problem.

Chairman CAMP. Yes, so it is a long wait. Is there another way that would bring this technology or this information to the market sooner and still provide legal protection to the author?

Mr. EVERSON. I don't think there is a lack of ideas in this area, as I have indicated, and as the Joint Committee staff has indicated. There is plenty of creativity and, in my view, sometimes too much.

Mr. TOUPIN. One of the consequences of a patent regime is that it does encourage those who are using strategies or methods of whatever kind who don't want them patented by others to publish them. We have worked with a number of areas to develop—help them develop ways of publishing their ideas where they don't want something patented in ways that we could access for purposes of making judgments about patent applications. That is a consequence of the patent system that can lead to more things being available as a byproduct of patenting.

Chairman CAMP. All right, thank you. The gentleman from Florida may inquire.

Mr. FOLEY. I arrived late, so I am trying to still get my hands around the conversation. Are we talking about patenting things like software that applies to tax compliance or are we talking about strategies, such as hedging against—using hedge funds or some other product in which to avoid taxes?

Mr. TOUPIN. I think both.

Mr. EVERSON. I draw the distinction in my testimony, sir. I say that because of the complexity of the Code, there are many products that help a taxpayer get through this terribly burdensome Code. That is a good thing. Your second piece, that is the area of concern.

Mr. FOLEY. Right, because I know into it are some of these other software devices or H&R Block named a number of people who have software that helps you process your return and make certain you have used every calculation necessary to get the best possible tax advantage. The other question becomes does patent protection provide some legal definition. Remember the cases they were using, some large brokerage houses will be anonymous for the moment, but using very creative real estate shelters and techniques in which to reduce income that have now been proven to be fraudulent and challenged in court. Some have gone to jail using those concepts. Does the patent provide any additional legal protection?

Mr. TOUPIN. No, and indeed the IRS has found that—looking at the patents that have issued, that indeed these aren't aggressive. They might be aggressive strategies if they were tweaked a little bit but they are not aggressive as patented. I think there is a reason for that. That is that the patent puts the method out for the whole world to see. Somebody who is trying to do something that is not quite kosher might not want that strategy being published for the whole world, including the Internal Revenue Service, to see.

Mr. FOLEY. I guess it is still hard to realize that if you are into the tax planning process, and the Code is fairly specific on items, deductions, and scenarios by which you may apply, how this novel idea of using the Code and using what is in law becomes patentable. I guess there is where I am scratching my head and say if I create a tax shelter like a hedge fund that creates an opportunity to shelter money but is using every mechanism available to me under the definition of Code, why is that a unique enough idea that I get a patent protection for it?

Mr. TOUPIN. Well, there is a variety of these patents and I can't speak to any one of them in particular. The original State Street Bank decision, which led to this growth, was about a means of tracking transactions to maximize the accountability of capital gains so that those could be captured and used. It was a hub and spoke method for accomplishing that purpose. The Federal Circuit Court held that that kind of a method, which optimized the ability to use—among other things a tax advantage, was useful subject matter that could be patented.

Mr. FOLEY. So, what they are doing in a particular instance is the timing element of their securities or whatever they were selling, they were using a program in which to determine whether it was ready for capital gains treatment?

Mr. TOUPIN. I am sorry, Congressman, I am sure that is a subject matter that you know a lot more about than I in terms of exactly how they are accomplishing.

Mr. FOLEY. No further questions.

Chairman CAMP. Thank you. Mr. Weller may inquire.

Mr. WELLER. Thank you, Mr. Chairman. Welcome to our panelists here. This is an interesting hearing, Mr. Chairman. I know when I was talking to some constituents yesterday, and I was telling them that you realize there are some people who want to patent tax advice and tax strategies, and the folks back home, their response was, "You got to be kidding." So, I appreciate having this what is kind of an unusual subject, something that caught a lot of people by surprise that this would be occurring, that people would be patenting advice and strategies in response to tax law.

Looking at this, I am interested in knowing the number of professionals at the PTO that are actually capable of assessing applications for tax patents? It is the novelty and utility of devices in which patents are sought requires expertise. I was wondering, Mr. Toupin, if you can share with us how many professionals with tax law or accounting backgrounds does PTO have employed?

Mr. TOUPIN. If I could read from a sheet of paper for you. We currently have 26 examines working in the finance area of business methods. Of that number, one examiner holds a Ph.D. in finance and is a past associate professor of finance at the University of Maryland and a past financial planner. Eight examiners have either a MBA or a master's in finance or are close to finishing the master's in finance. Four examiners have law degrees. One examiner has a master's in economics. One examiner worked as a chief accountant in a private firm. Two examiners have an undergraduate degree in finance. So, we have been looking in this area to put people who have educational and professional backgrounds that suit them well to this. As I indicated earlier, we have worked with the Office of Personnel Management to modify the classification for patent examiners to allow us on a pilot basis for a couple of years to hire people with financial type backgrounds who do not also have other technical backgrounds, and we are hoping to add to our expertise in that way.

Mr. WELLER. So, all these people that you have mentioned, what is the number again, 40?

Mr. TOUPIN. Well, there are 26 and I described——

Mr. WELLER. Twenty-six but all 26 of them are engaged on assessing these applications?

Mr. TOUPIN. I don't know exactly what the assignment is of each of these people. The finance area is broader than the tax.

Mr. WELLER. You feel there is a need to hire additional people to address this type of application?

Mr. TOUPIN. In the business methods area generally, which is a large and expanding area of our practice, we are looking. I can't say exactly when we expand that, how many of them will specifically be assigned to tax matters.

Mr. WELLER. Admittedly, this is a new subject for me, realizing people are patenting business and tax strategies. How widespread is an effort to patent business strategies, essentially putting something in paper and saying this strategy needs to be patented to protect our intellectual property rights?

Mr. TOUPIN. As I indicated, in terms of tax strategies in particular, and that describes a variety of different kind of structured processes, we have issued about 40. There are published——

Mr. WELLER. You have issued 40 patents on tax strategies already?

Mr. TOUPIN. Variously described. Some of them may or may not exactly fit the definition that you are using, and about 60 published applications. In the business method area as a whole, well, we are running about 8,500 applications a year. So, it is a very small part relative to the overall.

Mr. WELLER. Okay, thank you. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. Would any other Members seek to inquire? All right. I want to thank our witnesses very much for their very helpful testimony and appreciate your attendance. Thank you very much. We will now begin panel two, including Mr. Richard S. Gruner, professor of law at Whittier Law School; Ms. Ellen Aprill, associate dean of Academic Programs, professor of law at Loyola Law School; and Dennis Belcher, a partner at McGuireWoods of Richmond, Virginia. I want to thank you all for coming this morning. We do have your written testimony. You will have 5 minutes to summarize your statement and then we will go to questions after all three of you have an opportunity to make your statements. Why don't we begin with Mr. Gruner. Again, welcome, and thank you for being here.

STATEMENT OF RICHARD S. GRUNER, PROFESSOR OF LAW, WHITTIER LAW SCHOOL, COSTA MESA, CALIFORNIA

Mr. GRUNER. Mr. Chairman and Members of the Subcommittee, it is my honor and privilege to be here with you today and contribute to the efforts of this Subcommittee. Let me use my limited amount of time to summarize how I think we got here on this extraordinary occasion discussing the intersection of patent law and tax law, two areas of the law that until recently most parties would have said could not intersect. Yet, here we are.

The emergence of tax planning patents reflects the convergence of three important trends: one legal, one technological, and one professional. First, patentable subject matter standards have been steadily expanding in scope. Federal court standards have recognized over the past two decades that our patent system should encourage and reward advances in fields as divorced from traditional physical engineering and chemistry as bio-engineering, computer software, communication information processing, accounting recordkeeping, financial investment strategies, and business methods. In this march toward ever broader patent system scope, it is a small step to extend patents to advantageous tax planning methods, which produce important financial results for taxpayers.

Second, a technological trend. The impacts of computers and computer-based analyses have expanded the range of sophisticated tax planning strategies that are appreciated and implementable. Computer analyses of potential asset and income management strategies and tax results have expanded our understanding of what is desirable, leading to types of potentially patentable tax planning methods which would not have been understood a few years ago.

On the implementation side, computer management and tracking processes allow for the implementation of tax planning strategies which would not have been possible in an earlier era. These developments in computer technologies applied to tax planning methods have expanded the range of computer-related tax planning patents just as the presence of computers has expanded the number of patents in so many fields.

Finally, a professional change. The increasing issuance of patents in the financial and tax planning services fields may encourage firms to extend more resources toward the development of highly sophisticated methods for tax planning, with the amount of those resources augmented by expectations of large rewards achieved through patent control of the resulting innovations. If a given advance developed by a firm can only be marketed by the firm to that firm's particular client set, and may become available for marketing by competitors for disclosure of the method, the firm pursuing the development of the method will only be encouraged to devote such resources to the development of the method as will be paid back in extra payments from their own clients in later transactions.

However, if a firm can develop a sophisticated new tax planning strategy and know that it can look to patents as a source of rewards, the firm will be encouraged to develop that strategy with a devotion of greater resources, knowing that all the taxpayers who wish to benefit from using the method will need to pay a royalty to gain this advantage. Under this latter type of system, the full range of taxpayer advantages from a given new technique will define the extent of development expenditures that are justified in producing it. This system will also encourage firms to focus on the types of highly innovative, non-obvious extensions of prior designs that are capable of qualifying for patents.

This last analysis suggests why patents on tax planning methods, though highly foreign and seemingly dysfunctional to tax planners at this time, may ultimately be beneficial to this field. If the future of tax planning methods lays in highly sophisticated computer-intensive means of asset and income management, then substantial development rewards and protections may be needed to encourage the invention of these methods. Patents on such methods will encourage the very best designers of such methods to devote their time to this kind of development. Patents will also encourage the devotion of extensive combinations of computer and financial accounting resources for the development of these methods with the knowledge that the successful results can lead to valuable patents. This type of development pattern has prevailed in a number of other fields where patents serve to allow smaller, highly innovative concerns to focus on innovation with the assurance that other less innovative firms will need to pay for the use of the resulting innovations.

In short, a patent mediated world of tax planning may be one in which greater efforts are devoted to the types of innovative tax planning methods that are non-obvious advances over prior methods and that can qualify for patents. It may also lead to a restructuring in the field where innovators are significantly advantaged in competition with non-innovators and in which specialists in innovation can be sure that their useful results will be paid for by the numerous clients and tax specialists who use and benefit from the innovative tax planning methods which emerge. Thank you, and I look forward to answering your questions.

[The prepared statement of Mr. Gruner follows:]

Statement of Richard S. Gruner, Professor of Law, Whittier Law School, Costa Mesa, California

It is my pleasure to appear today to offer comments on the role of patents in protecting tax planning methods. A number of United States patents now apply to sequences of steps of asset and income management which are aimed at achieving advantageous tax results for taxpayers. The developers of these methods have claimed that their tax planning steps are significantly new and useful methods for achieving practical results and have accordingly obtained patents covering the methods. If valid, these patents will preclude other parties from using the patented method without the patent holder's permission.

Patents regarding these techniques are emerging as significant concerns within the tax planning community. Tax attorneys and other tax planning specialists have raised concerns that patents will limit their ability to provide valuable services to their clients and produce unexpected patent infringement liability for themselves and their clients. At the same time, parties seeking and obtaining these patents assert that they have developed advances in tax planning methods which are significant departures from earlier methods and deserving of the sorts of patent protections and rewards that have traditionally applied to useful advances.

For its part, the United States Patent and Trademark Office (USPTO) has implicitly agreed that advances in this field can qualify for patents by issuing a number of patents in this domain. Records of published patent applications regarding tax planning methods indicate that the number of patent applications in this field is growing, meaning that the number of issued patents and related patent disputes concerning tax planning patents is likely to expand in the future.

My comments today will not attempt to address all of the legal issues that may surround the issuance and enforcement of tax planning patents. I will focus on three principle areas. First, I will describe the ways that patents may influence the development of tax planning methods and other "intangible inventions" that entail the management of information and other intangible items for personal gain. Second, I will describe one of the existing tax planning patents and the manner in which it may be enforced against taxpayers, attorneys, accountants, and financial institutions. Third, I will suggest actions that will improve the quality of patents issued in this area, with the goal of maintaining the incentive effect of patents in this important area while diminishing the effect of improperly issued patents in deterring legitimate tax planning strategies.

I. *The Role of Patents in Promoting Tax Planning Innovations*

A. *Introduction to Utility Patents*

A patent for an invention gives the inventor the ability to control the use and commercialization of the invention for a limited period. A United States patent is granted based on an application to and review for legal sufficiency by the USPTO. Generally, the term of a new patent is 20 years from the date on which the application for the patent was filed in the United States. United States patents are effective only within the United States, U.S. territories, and U.S. possessions.

The right conferred by the patent grant is to exclude others from making, using, offering for sale, or selling the patented invention in the United States or importing the invention into the United States. 35 U.S.C. § 271(a). What is granted is not the right to make, use, offer for sale, sell or import the invention, but rather the right to exclude others from making, using, offering for sale, selling, or importing the invention. Once a patent is issued, the patentee must enforce the patent without aid of the USPTO.

There are three types of patents:

1. Utility patents covering new and useful devices, materials, and processes;
2. Design patents covering new, original, and ornamental designs for articles of manufacture; and
3. Plant patents covering distinct and new varieties of asexually reproducing plants.

When parties speak of patents, they usually mean utility patents. In the remainder of these written comments, the term "patent" refers to a utility patent. Utility patents are granted for new inventions that are useful, including procedures for undertaking a useful task. Most tax planning patents will be aimed at protecting useful procedures for obtaining desirable tax results.

Under the Patent Act, any person who "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," subject to the conditions and requirements of the law. 35 U.S.C. § 101. Advances falling within this statutory definition are "patentable subject matter." The word "process" in this standard is defined by law as a process, act or method. The term "machine" as used in the statute includes artificially created assemblages that operate on some other subject matter, often transforming that additional matter. The term "manufacture" refers to articles that are made, and includes all manufactured articles. The term "composition of matter" relates to chemical compositions and may include mixtures of ingredients as well as new chemical compounds. These classes of subject matter taken together include practically everything that is made by man and the processes for making the products.

The Patent Act specifies that patentable inventions must be "useful." The term "useful" in this connection refers to the condition that an invention has a useful purpose and operates to achieve its intended purpose. Court cases have held that steps for expanding financial profits or keeping track of financial activities in a useful way are examples of processes that meet the utility requirements of the patent statute. In light of this, tax planning methods leading to advantageous tax results and lower tax liabilities for taxpayers are likely to be seen as having sufficient practical utility to qualify for a patent.

Judicial interpretations of the Patent Act have defined some limits on the field of subject matter that can be covered by a utility patent. For example, it has been held that laws of nature, naturally occurring phenomena, and abstract ideas are not patentable subject matter.

A patent cannot be obtained upon a mere idea or suggestion. A patent is only available for a new machine, manufacture, chemical or process with specific, implementable details and not for the idea or suggestion of the new invention. A complete description of the actual machine or other subject matter for which a patent is sought is required in a patent application and in the resulting patent if one issues.

In order to qualify for a patent, an invention must not only be new (that is, different from prior designs publicly known as of the date of invention), but also a non-obvious departure from the prior knowledge in the field. *See* 35 U.S.C. § 103. In order to determine if this is the case, it is necessary to consider the state of the prior knowledge in the field (commonly referred to as the "prior art") at the date an invention was made, the differences of the invention from the prior art, and whether a party of average skill in the field was likely to be able to develop those differences. If the average practitioner was capable of developing the invention under these circumstances, then the invention is considered to be an obvious advance and not properly patentable. *See id.*

B. *Expanding Application of Patents to Intangible Innovations*

1. *Open Ended Extension of Patents to New Technologies and Domains*

Some parties have argued that historical notions of engineering and patentable subject matter should govern the outer boundaries of the patent system. Up until a few decades ago, patents were applied almost exclusively to promote the development of physical technologies, including physical devices, materials, and processes. A continuing emphasis on this history would support a view of the patent system that was limited to the types of advances emerging from useful trades or industrial activities in the past.

However, courts have thus far seen the patent system as far more dynamic than this. They have interpreted Congress's will in enacting patent laws to be that incentives should exist under those laws to expand the boundaries of what we consider to be technology and useful inventions. With this notion of evolving patterns of innovation and product and services characteristics have come major new advances that turn primarily on changes in the intangible features of modern goods and services. Persons need reach no further than their purses or pockets for their cell phones to locate a primary example of this new trend in innovation. Cell phone advances have turned largely on information processing breakthroughs and the associated abilities of companies around the world to implement and manage highly complex communication systems to support cell phone calls. Many of the key technology breakthroughs in this field were patented under the expanded notions of information processing patents and technologies applied in recent years.

In general, courts have adopted a highly inclusive view of what is a new and useful advance that is potentially patentable. By viewing the patent system as a forward-looking institution with the aim of encouraging useful designs well beyond our present knowledge, courts have rejected a view of patentable subject matters that would look to the past and limit patents to historically important lines of innovation. Rather, courts have disengaged definitions of patentable subject matter from old notions of technologies or industrial practices. Indeed, a failure to take this sort of encompassing view of the potential range of patentable inventions would risk rendering the patent system irrelevant amidst modern modes of technological advance. Actual patterns of technological advance and application should dictate the directions of valuable additions to consumer products and the patent system must keep up by extending patents to the full range of innovations that are widely replicable, distributable, and, therefore, of widespread public importance.

2. *Emphasis on Patents Regarding New Information Technologies*

The result of this view of patentable subject matter has been a trend towards the patenting of advances that emphasize information processing methods and devices incorporating such methods. Examples of fields in which information processing advances have been highly important—as vehicles for both commercially significant products and highly valuable patents—have included:

Biotechnology—Use of DNA-based information for diagnostic procedures and biological product designs

Computer Controls—Use of advanced information processing technologies to control older devices and processes

Communications—Use of new information processing methods to increase the volume and quality of communications systems

Interpretive Systems—Use of information processing advances aimed at squeezing new insights out of existent information (e.g., heart monitor data processing systems or seismic data analysis systems)

3. *Judicial Analyses Embracing Broad Views of Patentable Subject Matter*

While there are many other examples in the case law of federal courts, the following highlights illustrate the broadly inclusive views that federal courts have taken of patentable subject matters. These cases define a path that leads to the coverage of patents for numerous information processing advances, financial management methods, and, by little or no extension, tax planning processes.

a. *Biotechnology*

In *Diamond v. Chakrabarty,* 447 U.S. 303 (1980), Chief Justice Berger, writing for the Supreme Court, held that United States patent laws extend to advances in biotechnology including a newly bioengineered type of bacteria that was useful in helping to break down oil products and clean up oil slicks. The Court observed that the patent system should not be limited to older notions of what constituted technology or engineering. Rather, the Court felt that Congress intended patentable subject matter to include "anything under the sun that is made by man." *Id.* at 308.

b. *Computer Systems for Information Processing*

In re Alappat, 33 F.3d 1526 (Fed.Cir. 1994) (en banc) involved a computer system for controlling visual output on a video screen. A computer system carefully evaluated electronic signals and determined how to best display the signals on a video screen. The only new components in computer system were the information processing sequences defined by the applicable computer program. The Court of Appeals for the Federal Circuit found this invention to entail patentable subject matter because the system was "a specific machine that produces a useful, concrete, and tangible result." *Id.* at 1544.

c. *Financial Information Processing Method*

State St. Bank & Trust Co. v. Signature Fin. Group, Inc., 149 F.3d 1368 (Fed.Cir. 1998) considered a patent on a business method calling for central investment of funds from multiple financial institutions, with frequent status reports made to the contributing institutions (a so called "hub and spoke" system of investment and reporting). This method was found to be a patentable process because the information handling involved had practical consequences in managing funds. The Federal Circuit court specifically noted that, given their practical consequences, business methods should be treated no differently than other practical advances and that innovative business methods should qualify as patentable subject matters like other useful advances.

d. *Business Record Keeping Method*

The Federal Circuit court reaffirmed its support for business method patents in *AT&T Corp. v. Excel Communications, Inc.*, 172 F.3d 1352 (Fed.Cir. 1999). That case involved a new electronic record keeping method for handling information on long distance calls. This method was found to be patentable subject matter based on the practical usefulness of the method in phone usage record-keeping and associated billing systems.

e. *Medical Information Processing Method*

In Arrhythmia Research Technology, Inc. v. Corazonix Corp., 958 F.2d 1053 (Fed.Cir. 1992) the Federal Circuit court considered the patentability of a computer-implemented method for interpreting heartbeat monitor data to detect possible heart problems. This system was patentable because the results it produced were not abstract data but rather information "related to the patient's heart activity." Patentable subject matter was present here because heartbeat monitor signals were "transformed" to produce a practically useful result in identifying heart abnormalities. Id. at 1059.

4. *General Standard For Patentable Subject Matter in Intangible Innovations*

The cases to date—particularly the rulings of the Court of Appeals for the Federal Circuit which hears all patent appeals—indicate that a new method of undertaking a useful procedure will be a potentially patentable innovation if the method:

- Fills a user need with identifiable value;
- Addresses a need shared by multiple parties;
- Operates in a regular manner producing consistent results; and
- Is capable of being described clearly so as to permit effective evaluation of the innovation and its results by potential users.

See generally Gruner, *Intangible Inventions: Patentable Subject Matter for an Information Age*, 35 Loyola L.A. L. Rev. 355 (2002). An innovative tax planning method, capable of use by a broad set of taxpayers and producing favorable, valuable tax results, would appear to meet this standard for patentable subject matter.

C. *Potential Impacts of Tax Planning Patents*

Commentators analyzing the development of patents regarding financial services and products have identified a number of ways that such patents are changing the way businesses in this field operate. These developments concern how businesses in the financial services field are perceived by customers, the choices these business make regarding the targeting of innovation and marketing efforts, and the relative mix of innovators versus non-innovators in the field. The same sorts of impacts are likely to be seen in the tax planning field as tax planning patents become more common and have greater impact. *See*, *e.g.*, James F. Baueric, "*Beam Me Up, Scotty*"; Business Method Patents as a Transformational Device in Financial Services, 119 Banking L.J. 376 (2002); John C. Spaccarotella, *Patents Continue to Gain Visibility, Value in the Lucrative Derivatives, Hedge Fund, and Allied Financial Services Market*, Futures & Derivatives L. Rep., Oct. 2005 at 3.

1. *Expertise Validation*

One impact of patents obtained for particular financial services is to validate the apparent expertise of the developers of the patented services. The issuance of a patent is viewed as a confirmation by the USPTO that the patented financial service or product is a distinctive departure from the prior knowledge in the field. The approval of the patent by the PTO indicates that its neutral patent examiners have compared the claimed invention to the prior knowledge in the field and found the invention to be a nonobvious addition to that knowledge. The patent, as a symbol of the underlying analysis by the USPTO, therefore becomes credible evidence of both the newness of the patented invention and of the analytic skill of the invention developer in being able to produce a nonobvious extension of prior designs.

This is a reflection of the "signaling" role of patents regarding technological developments generally. Clarisa Long, *Patent Signals*, 69 U. Chi. L. Rev. 625 (2002). As described by Clarisa Long, patents provide:

"a means of credibly publicizing information. Patents can reduce informational asymmetries between patentees and observers. Under some circumstances, the informational function of patents may be more valuable to the rights holder than the substance of the rights. . . . If an easily measurable firm attribute such as patent counts is positively correlated with other less readily measurable firm attributes such as knowledge capital, then patent counts can be used as a means of conveying information about these other attributes. Knowing this, firms may choose to obtain and use a portfolio of patent rights to signal information about themselves that would be more expensive to do through other means. Alternatively, firms can use the patent document itself to convey information that would not be as credible when revealed in other contexts." *Id.* at 625.

2. *Product Differentiation*

Another impact of issued patents in the financial services industry is to differentiate products of patent holders from those of competitors. A company marketing a particular financial services product incorporating a patented features can assure its customers that this same product—and whatever advantages it provides—can not be obtained from other vendors since the patent involved will preclude adoption of the feature in other parties' products and services. Through this type of product differentiation, a firm can establish a pattern of "sustainable differentiation" from its competition built on a foundation provided by the firm's patents. *See* Spaccarotella, *Patents Continue to Gain Visibility, Value in the Lucrative Derivatives, Hedge Fund, and Allied Financial Services Market*, Futures & Derivatives L. Rep., Oct. 2005 at 3 (noting the potential of financial services patents to enhance the marketing of an "allegedly-proprietary product and technology to current and potential clients").

This type of sustainable differentiation has been seen as highly valuable in other fields. In a detailed study of patenting and investment generation practices in the computer software field, Ronald J. Mann found that venture capitalists were particularly interested in patents and associated them with company value because the patents provided a vehicle for sustainable differentiation of software developers from their competitors. Ronald J. Mann, *Do Patents Facilitate Financing in the Software Industry?*, 83 Tex. L. Rev. 961 (2005). Mann described the linkage between patent holdings and perceived company value in the eyes of venture capitalists as follows:

"[F]or firms that have a credible product idea and the expertise to implement it, venture capitalists plainly accept the idea that their goal is to identify firms that will have sufficient market power to earn extraordinary profits. IP protection is important only indirectly, as a tool that might provide that market power. The key is "sustainable differentiation": something special about the particular firm that will enable it to do something that its competitors will not be able to do for the immediate future. . . . [I]t is clear that the key to a desirable investment opportunity is in the expectation of market power, and all other attributes of the company are indirect predictors of that ultimate goal." *Id.* at 975 (footnotes omitted).

3. *Channeling Competitors' Actions*

Patent issuance, coupled with substantial publicity regarding a patent and its probable enforcement, can be a means to either direct competitors' activities away from a particular domain of product development and offerings or to compel competitors to seek licenses and pay handsome royalties for access to products or services that are so essential that they can not realistically be avoided. The motivation to either avoid infringement of a competitor's patents or to voluntarily seek a license stems from the considerable threat of patent infringement damages for parties who make, use, or sell a patented invention without the permission of the patent holder.

In a services setting, persons who undertake a patented service even without notice of the patent involved, are liable to the patent holder for compensatory damages. 35 U.S.C. § 284. Once a party is on notice of a patent and the practices or devices the patent covers, subsequent efforts by the party to make, use, or sell the invention risk not just compensatory liability, but also further punitive liability for willful patent infringement which can equal as much as three times the losses of the patent holder. *See Stickle v. Heublein, Inc.*, 716 F.2d 1550, 1556 (Fed.Cir. 1983). If the patent holder is a producer or provider of competing products or services, the patent holder's losses will be measured from the lost sales profits resulting from the infringer's conduct, provided that those profits can be proven accurately. *See Panduit Corp. v. Stahlin Bors. Fibre Works, Inc.* 575 F.2d 1152 (6th Cir. 1978). If the patent holder is not a producer of products or provider of services or if the patent holder's lost sales profits can not be proven accurately, a patent holder will be entitled to recover a reasonable royalty from an infringer equal to the amount of the royalty payment that the patent holder and infringer would probably have agreed to in negotiations conducted at arms length prior to the infringement. *Id.*; *Hanson v. Alpine Valley Ski Area, Inc.*, 718 F.2d 1075 (Fed.Cir. 1983).

When combined with the incremental threat of trebling for willful infringement, patent infringement damages can easily rise to large levels, making the threat of liability for such damages a considerable deterrent to actions even approaching patent infringement.

4. *Signaling Future Innovation Strengths*

Patents concerning a particular type of product can also signal future business strategies to customers and competitors. The investment of large research expenditures in developing new financial products or services in a particular area, coupled with the revelation of those expenditures through the publication of patent applications or patents describing inventions resulting from the innovative efforts, can provide business intelligence information to customers and competitors.

For customers, the message is that the firm involved is serious about being a technology and product leader in the domain of the innovation being patented, with the possibility of more similar advances to come. Such a message can establish a degree of trust in the future products of an innovative patent holder that encourages customers to establish long term business relationships with the innovator.

For competitors of a patent holder, the implications of a valid patent may be that the competitors will find it difficult to pursue innovation in the same direction as the innovation covered by the patent (since they will need to license rights under that patent in order to pursue such innovation) and that the competitors will need to pursue other paths of innovation departing significantly from the patented approach if they want to be innovators in the same field. This pressure to "design around" an existing patent and produce alternative solutions to consumer problems that are outside the patent can drive innovation efforts of competitors into other areas that are unaddressed by the patent holder.

5. *Increasing Innovation Specialization*

As a patent holder and its competitors pursue different innovative paths in reaction to an issued patent, each has incentives to develop specialized expertise and knowledge that will aid it in producing innovations and, perhaps, additional patents that will reserve a particular product niche to the firm. This type of strategy will tend to strengthen the specialization and firm differentiation effects in the field involved.

As this process goes forward, specialized innovators may need to cross-license patents to and from their competitors so that each can gain the specialized advances of the other to produce viable, competitive products. The patents that each firm has on their specialized advances in the narrow slice of the field where they have particularly strong innovative capabilities will become the "currency" with which they can bargain for rights to use the advances of their competitors.

6. *Rewarding Innovators Over Non-Innovators*

The winners in this sort of arrangement will be those firms that have innovations and patents which enable them to be highly successful competitors in the field. The losers will be companies with no innovations and no patents to bargain with. In effect, this sort of process should help to filter out less innovative firms, leaving only ongoing innovators that can bargain for the latest designs in their fields and keep the firms competitive in consumer markets.

II. *Anatomy of a Tax Planning Patent and Its Potential Enforcement*

In order to appreciate the potential scope and enforcement impact of patents on tax planning methods, it is useful to consider the terms of one of these patents. This section will briefly describe a patent issued in 2003 covering a method for achieving an advantageous tax result by establishing and managing in a specified fashion a trust funded by a particular type of stock options.

A. *The SOGRAT Patent*

United States patent number 6567790 purports to protect:

"[a]n estate planning method for minimizing transfer tax liability with respect to the transfer of the value of stock options from a holder of stock options to a family member of the holder. The method comprises establishing a Grantor Retained Annuity Trust (GRAT) funded with nonqualified stock options. The method maximizes the transfer of wealth from the grantor of the GRAT to a family member by minimizing the amount of estate and gift taxes paid. By placing the options outside the grantor's estate, the method takes advantage of the appreciation of the options in said GRAT."

U.S. Patent No. 6567790. A "nonqualified stock option" for tax law purposes is any stock option that does not qualify as an incentive stock option (ISO) and which does not receive the favorable tax treatment accorded to ISOs. Generally, a nonqualified stock option is not taxed at the date it is granted, but is instead taxed upon the exercise of the option. The amount subject to tax is the difference between the fair market value of the stock on the date of the exercise of the option and the exercise price paid for the stock. After the exercise of an option, the taxpayer holds the corresponding stock as a capital asset and is subject to normal capital gains rules on the disposition of the stock.

Because the GRAT used in this method involves stock options, the patent applicant describes this method as involving a "Stock Option Grantor Retained Annuity Trust" or "SOGRAT." As a further measure of intellectual property protection, the patent applicant claims trademark protection for the use of the term "SOGRAT" (this claim is noted in the patent covering the method). In the remainder of this document, the above patent is referred to as the "SOGRAT patent."

B. *Scope of Protection*

The scope of protection granted by this patent can only be gauged from the claims stated in the patent. These claims, located at the end of the patent document, describe the "metes and bounds" of the legal rights conferred by the issuance of the patent. The patent holder will be able to prevent others from using a tax planning method only if the method of the other party is with the description of the protected process provided by the claims. In patent law terms, a tax planning method of a party other than the patent holder will be infringing if the claims describe or "read on" the method of that other party.

The SOGRAT patent has a number of claims describing different versions of the claimed method. The first claim is the broadest and reads as follows:

"What is claimed is:

1. A method for minimizing transfer tax liability of a grantor for the transfer of the value of nonqualified stock options to a family member grantee, the stock options having a stated exercise price and a stated period of exercise, the method performed at least in part within a signal processing device and comprising: establishing a Grantor Retained Annuity Trust (GRAT); funding said GRAT with assets comprising stock options, the stock options having a determined value at the time the transfer is made; setting a term for said GRAT and a schedule and amount of annuity payments to be made from said GRAT; and performing a valuation of the stock options as each annuity payment is made and determining the number of stock options to include in the annuity payment."

The portions of this claim separated by semicolons identify the steps or elements that a tax planning process will need to have to fall within this claim and to be infringing. These elements provide a checklist for analyzing the activities of other parties for the purpose of determining if they are infringing this patent. Using this approach, a party would appear to infringe this patent (assuming that the patent is valid and enforceable) if the party (using, at least in part, a "signal processing device") completed the following steps:

1. establishing a Grantor Retained Annuity Trust (GRAT);
2. funding said GRAT with assets comprising stock options, the stock options having a determined value at the time the transfer is made;

3. setting a term for said GRAT and a schedule and amount of annuity payments to be made from said GRAT; and

4. performing a valuation of the stock options as each annuity payment is made and determining the number of stock options to include in the annuity payment.

Assuming that a tax planning method had these features, it would be infringing, even if the method had other details or characteristics. If a method did not include exact counterparts to every one of these steps, it would still be infringing if it included an equivalent action to each of these steps. A step will generally be seen as an equivalent of a claimed step if the alternative step involves a similar means of operation, function, and result to the counterpart step in the patent claims.

C. *Potential Infringers*

1. *Clients*

Clients for whom tax planning methods are implemented and who benefit from the resulting taxation outcomes would be the primary or "direct" infringers of a patented method like that described above. A party seeking to implement this strategy without the patent holder's permission could be enjoined from doing so. A party who implemented the patented method (even without being aware of the patent involved) would be liable for patent infringement damages equal to a reasonable royalty payment for use of the patented method. 35 U.S.C. § 284. If the party was aware of the patent and aware that the course of conduct he or she contemplated was apparently covered by the patent, but went ahead anyway with the infringing conduct having no good faith reason to believe that it was non-infringing or that the patent was invalid, the party could be held liable for punitive damages of up to three times the patent holders compensatory damages. *Id.*

2. *Attorneys/Accountants*

The federal Patent Act holds persons who induce others to engage in patent infringement equally liable with the parties who actually undertake the infringement. 35 U.S.C. § 271(b). The notion here is that an inducer is essentially an "aider and abetter" of the patent infringer and should be equally responsible for patent damages. Numerous cases hold that persons who instruct others how to infringe a patent or who help to design implementations of an infringing design are deemed to be inducers of infringement and liable under the Patent Act. Since tax attorneys and accountants who specialize in tax matters will commonly provide advice, instruction, and relevant document creation services aiding clients in setting up tax planning strategies, if these professionals are aware that the tax planning methods that they are helping clients to implement are patented, attorneys and accountants may incur patent infringement liability by inducing the patent infringement of their clients.

In order to establish liability for inducement of patent infringement, the following elements must be proven by a preponderance of the evidence: (1) an inducer's knowledge of the asserted patent; (2) the presence of infringement by the party allegedly induced; (3) an inducer's actual intent to cause the acts which he knew or should have known would induce actual infringements; and (4) the commission of a positive act that materially furthers the infringement, not merely the power to act or the failure to act. *TI Group Automotive Systems, (North America), Inc. v. VDO North America L.L.C.*, 62 USPQ2d 1599, 1601 (D. Del. 2002); *see also Black & Decker (US) Inc. v. Catalina Lighting, Inc.*, 953 F. Supp. 134, 138 (E.D. Va. 1997). Where a tax attorney or accountant is aware of a tax planning method patent and instructs a client or materially assists a client in carrying out the patented tax planning method, all of these criteria would seem to be met.

3. *Financial Institutions Managing Accounts*

Financial institutions or other entities that agree to carry out a patented tax planning method (perhaps by establishing or acting as trustee for the relevant trust) may also carry out the patented steps and be liable as a direct patent infringer. Here, the financial institution would be acting as the agent of the taxpayer for whom the infringement was undertaken, but this will not undercut the fact that the institution has carried out the patented steps and has acted as an infringer.

III. *Potential Steps to Limit the Issuance and Enforcement of Improper Tax Planning Patents*

A number of steps may be useful in ensuring that tax method patents are limited to innovative tax planning methods that are significant, nonobvious departures from prior methods in this field. This section summarizes these possible strategies for future action.

A. *Identify Field-Specific Prior Art Sources for Use in Patent Examination Processes and Enforcement Disputes*

Tax specialists might profitably work with the USPTO to identify publicly accessible sources of information about past tax planning strategies so that these known strategies can be taken into account in the processing of applications for patents on tax planning methods. These prior art sources are different in both location and content from many other types of information commonly considered by patent examiners and a complete picture of the prior art against which tax method patent applications should be measured may require personnel in the patent office to gain new information on the sources and meaning of publicly available descriptions of "state of the art" tax planning methods. This same information on sources and implications of prior art, if made available to the public, would assist defendants in patent cases to challenge the validity of improvidently issued patents on tax planning methods.

B. *Develop Means to Expand the Knowledge of Patent Examiners Regarding Tax Planning Methods and Improvement Patterns*

To the extent that methods of tax planning and techniques for extending prior tax planning methods to produce new methods are unfamiliar to patent examiners, presentations by tax practitioners to USPTO personnel on current tax planning techniques may be highly valuable. These sorts of presentations might be modeled on similar information sessions that the USPTO conducted to learn more about computer software programming methods and advances in the period when software patents and their examination were growing concerns for the Patent Office.

C. *Encourage the Patent Office to Frequently Reexamine Tax Planning Patents*

The USPTO has the ability to reexamine and invalidate issued patents in light of prior art that was not originally considered in the initial examination of the patents. Given the uncertain state of prior art in the field of tax planning patents, a policy adopted by the Patent Office which encourages the submission of prior art in this field to trigger reexamination proceedings might be a valuable means to ensure that unwarranted patents do not reach the stage of active enforcement.

D. *Develop an Information Distribution System to Inform Tax Practitioners of Assertedly Restricted Tax Planning Methods*

An additional useful advance might be a system for better informing tax practitioners regarding the issuance of patents on particular tax planning methods to prevent the inadvertent implementation of a patented strategy without gaining appropriate permission from the patent holder. This type of information distribution system might be as simple as a means for specially flagging patents on tax planning methods in the patent records system or otherwise identifying patents in this category to facilitate quick searching for patents affecting this type of legal practice. The Patent Office has begun to implement a special coding system for patents in this field, but it is unclear that all of the relevant patents are being identified by the appropriate coding. The Patent Office also might consider the issuance of special reports on this category of patents given their new character and the general unfamiliarity of many tax practitioners with the types of tax planning patents that are emerging.

E. *Implement a Public Comment System Whereby the IRS Notes the Ineffectiveness or Impropriety of Patented Tax Planning Methods*

As a matter of taxpayer protection, a system under which the IRS identifies patented tax planning methods as either abusive or incapable of achieving a meaningful tax advantage would help taxpayers and their attorneys and accountants to properly discount the value of the patented methods involved and to avoid those practices. To the extent that recognizing a tax planning method with a patent suggests that the method is particularly special and valuable, this type of corrective information from the IRS might be needed to ensure that taxpayers and tax specialists make decisions about tax planning methods with an accurate picture of the merit of the methods involved.

IV. *Conclusion*

The emergence of tax planning patents reflects the confluence of three important trends in patent law. First, patentable subject matter standards have been steadily expanding in scope. Federal court standards have, over the past two decades, recognized that our patent system should encourage and reward advances in fields as divorced from traditional physical engineering and chemistry as bioengineering, computer software, communication information processing, accounting record keeping, financial investment strategies, and business methods. In this march towards ever broader patent system scope, it is a small step to extend patents to advantageous tax planning methods which produce important financial results for taxpayers.

Second, the impacts of computers and computer-based analyses have expanded the range of sophisticated tax planning strategies that are appreciated and implementable. Computer analyses of potential asset and income management strategies and tax results have expanded our understanding of what is desirable, leading to types of potentially patentable tax planning methods which would not have been understood a few years ago. On the implementation side, computer management and tracking processes allow for the implementation of tax planning strategies which would not have been possible in an earlier era. These developments in computer technologies applied to tax planning methods have expanded the range of computer-related tax planning patents just as the presence of computers has expanded the number of patents in so many fields. *See generally* Gruner, *Better Living Through Software: Promoting Information Processing Advances Through Patent Incentives*, 74 St. John's L. Rev. 977 (2000).

Third, the increasing frequency of patents in the financial and tax planning services fields may encourage firms to extend more resources towards the development of highly sophisticated methods for tax planning, with the amount of those resources augmented by expectations of large rewards achieved through patent control of the resulting innovations. If a given advance can only be marketed to a given firm's particular client set and may become available for marketing by competitors through public disclosure of the method, the firm pursuing the development of the method will only be encouraged to devote such resources to the development of the method as will be paid back in extra payments from their own clients in later transactions. However, if a firm can count on patent protections for a new and highly innovative tax planning strategy, the firm will be able to afford to devote greater resources to the development of the method knowing that all taxpayers who wish the benefit of using the method will need to pay a royalty to gain this advantage. Under this latter type of system, the full range of taxpayer advantages from a given new technique will define the extent of development expenditures that are justified in producing it. It will also encourage firms to focus on the types of highly innovative, nonobvious extensions of prior designs that are capable of qualifying for patents. *See generally* Gruner, *Everything Old is New Again: Obviousness Limitations on Patenting Computer Updates of Old Designs*, 9 B.U. J. of Science and Tech. L. 209 (2003).

This last analysis suggests why patents on tax planning methods, while highly foreign and seemingly dysfunctional to tax planners at present, may ultimately be beneficial to this field. If the future of tax planning methods lies in highly sophisticated, computer-intensive means of asset and income management, then substantial development rewards and protections may be needed to encourage the invention of these methods. Patents on such methods will encourage the very best designers of such methods to devote their time to this development. Patents will also encourage the devotion of extensive combinations of computer and financial accounting resources to the development of these methods with the knowledge that successful results can lead to valuable patents. This type of development pattern has prevailed in a number of other fields where patents serve to allow smaller, highly innovative concerns to focus on innovation, with the assurance that other, less innovative firms will need to pay for use of the resulting innovations.

In short, a patent-mediated world of tax planning may be one in which greater efforts are devoted to the types of innovative tax planning methods that are nonobvious advances over prior methods and that can qualify for patents. It may also lead to a restructuring of the field where innovators are significantly advantaged in competition with non-innovators and in which specialists in innovation can be sure that their useful results will be paid for by the numerous clients and tax specialists who use and benefit from the innovative tax planning methods which emerge.

Chairman CAMP. Thank you very much. Ms. Aprill, you have 5 minutes as well.

STATEMENT OF ELLEN APRILL, ASSOCIATE DEAN OF ACADEMIC PROGRAMS, PROFESSOR OF LAW, AND JOHN E. ANDERSON CHAIR IN TAX LAW, LOYOLA LAW SCHOOL, LOS ANGELES, CALIFORNIA

Ms. APRILL. Mr. Chairman, Members of the Committee, thank you for inviting me here today. This morning, I would like to discuss three points briefly: first the practical issues raised by tax strategy patents, first; second, how we might improve the quality of such patents; and, third, how the policy behind tax laws and patent laws compare. In brief, I want to suggest to you that because tax strategy patents constitute a government-granted monopoly regarding interpretation of and compliance with Federal laws, they differ from other business method patents in ways that raise concerns among all of us and require attention from the Subcommittee, the PTO, the IRS, the Treasury, and associations of tax professionals.

First, the impact on tax practice. The adverse consequences for infringing or inducing the infringement of patents can be substantial. If tax patents proliferate, tax professionals who are advising clients on ordinary transactions will need to begin to conduct patent searches and seek expert advice to protect themselves and their clients. I wanted to stress the concern for the individual client. Moreover, the proliferation of tax strategy patents could affect professional culture. Historically, tax lawyers have shared information and ideas freely. If patents become an important part of the landscape, the atmosphere will become more secretive, less cooperative, and the tax system as a whole will suffer.

Second, improving the patent examination process. As we have heard today, this is a new area for patent examiners. To ensure that, the quality of patents that are granted, the tax community, both public and private, need to assist patent examiners in understanding the tax law and in identifying prior art in non-patent literature. As you have heard, such efforts have begun and they need to be expanded. As we have also heard, under the patent law, however, questions of tax policy are not for the Patent Office; they are for Treasury and the IRS to decide. I suggest that Treasury and the IRS establish a program letting everyone know they are going to be reviewing tax patents to prevent any abuses. I suggest that some changes be made so that IRS and Treasury can see the patent application sooner. Again, I want Treasury to be involved as well because of the policy concerns raised by the ordinary transactions, and not only the extraordinary tax shelter ones.

Finally, let me turn to a comparison to patent policy and tax policy. The fundamental purpose of providing patents, as I understand it, is to promote innovation. Again, as we have heard, there does not seem to be a lot of need to provide economic incentives for the development, promotion, and implementation of tax planning strategies. The purposes of our tax laws is to raise money for the government to protect the public. Granting a government monopoly in the form of a patent that could undermine this key Federal function, the collection of revenue, and affect compliance with Federal law seems peculiar to me, if not contradictory, and raises fundamental questions about the appropriateness of such patents. We need the policy people to work on that basic question.

Of course, any decision to limit patent protection legislatively should be taken only after much deliberation and study. My hope is that this hearing will be the first step in careful consideration of any such step. One idea I would throw out for your consideration is parallel a provision that we see for medical procedures, to consider having a statutory protection against infringement or individual taxpayers in their individual capacity and as well as small businesses up to a certain amount. Thank you.

[The prepared statement of Ms. Aprill follows:]

Statement of Ellen Aprill, Associate Dean of Academic Programs, Professor of Law, and John E. Anderson Chair in Tax Law, Loyola Law School, Los Angeles, California

Mr. Chairman and members of the Subcommittee, thank you for inviting me to speak here today. My name is Ellen Aprill. I am the John E. Anderson Professor of Tax Law and Associate Dean for Academic Programs at Loyola Law School in Los Angeles; I have had the privilege of serving in the Office of Tax Legislative Counsel in the Department of the Treasury in the late 1980's and as a law clerk to the Hon. Byron R. White, Associate Justice of the United States Supreme Court, in the early 1980's. I am currently a member of the Council of Directors of the American Bar Association Section of Taxation. While I first became aware of the issues related to the patenting of tax strategies through my involvement on the ABA Tax Section, I am speaking today in my individual capacity as a tax lawyer and tax professor. My comments represent my own personal views and are not necessarily those of Loyola Law School or any other organization with which I am affiliated.

Tax strategy patents are considered a subcategory of business method patents.[1] Representatives of the United States Patent and Trademark Office ("PTO"), who have been most generous, gracious, and helpful in discussing these matters, have explained that the PTO classifies tax strategy patents as subclass 36T in Class 705, "Data Processing: Financial, Business Practice, Management, or Cost/Price Determination."[2] The PTO website shows that 48 patents have been issued in that subclass and 81 such applications are pending.[3] These tax strategy patents have involved many aspects of the tax law, including financial products, charitable giving, estate planning, and tax-deferred exchanges.

The topic of patenting tax strategies raises a broad range of issues, from the most theoretical to the most practical. Questions of theory and policy include whether it is desirable for the patent law to authorize tax strategy patents and whether the government monopoly granted to a patent holder is fundamentally inconsistent with the policies underlying our tax system. Important practical issues include the impact on how tax practitioners advise their clients and their potential liability for inducing patent infringement. Issues in the middle of this spectrum include questions of institutional capacity, namely how best to ensure the quality of such patents.

Like other tax lawyers who have looked at this issue, I have concerns both about tax strategy patents that may not meet the patent criteria of novelty and non-obviousness and about others that may be novel and innovative, but are inconsistent with our tax laws. My testimony will address both categories, although I am, in fact, more concerned about the former—tax strategy patents that are not in fact novel—than the latter, tax strategy patents that are inconsistent with the tax law. I will begin with the practical issues raised by tax strategy patents, go on to the consideration of how we might improve the quality of tax strategy patents, and end by comparing the purposes of the tax law with the purposes of the patent law. In brief, I conclude that because a tax strategy patent constitutes a government-granted monopoly that turns on the interpretation of federal law, tax strategy patents differ from other business method patents in ways that require attention and action from the PTO, the IRS, associations of tax professionals, and this Subcommittee.

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[1] After State Street Bank & Trust v. Signature Financial Group, Inc., 149 F.3d 1368 (Fed. Cir. 1998), held that business methods could be patentable subject matter, the number of business method patents exploded. Criticism of the concept of business method patents and the ability of the PTO to consider adequately prior art quickly followed. *See* Jay Dratler, Jr., *Does Lord Darcy Yet Live? The Case against Software and Business-Method Patents,* 43 Santa Clara L. Rev, 823 (2003); *cf.* John R. Allison and Emerson H. Tiller, *The Business Method Patent Myth,* 18 Berkley Tech. L.J. 987 (2003).

[2] *See* http://www.uspto.gov/go/classification/uspc705/sched705.htm.

[3] *See* http://www.uspto.gov/patft/index.html (using search term ccl/705/36T in Advanced Search).

A. Tax Strategy Patents Could Change and Burden the Practice of Tax Law

Compliance with the tax laws is enormously expensive and time consuming. However diligent and well-intentioned taxpayers and their advisers may be, compliance becomes more difficult every year. Proliferation of tax strategy patents will add to that difficulty. Tax practitioners and taxpayers will have to become more sensitive to the possibility that a tax strategy has been patented and adjust behavior accordingly.

The adverse consequences for violating or inducing the violation of patents can be substantial. Patent holders generally seek injunctions against alleged infringers as well as any inducers of infringement to bar them from acting without paying damages equal to lost profits or a reasonable royalty. A taxpayer can infringe a patent without intent or actual knowledge of the patent; ignorance of an applicable patent is not a defense to an infringement action. Moreover, patents have a presumption of validity; an alleged infringer defending use of a technique must show the invalidity of a patent by clear and convincing evidence. Patent infringement litigation is extraordinarily expensive.[4] Tax advisers whose clients face patent infringement suits may themselves face malpractice claims.

As a result, taxpayers, their advisers, and others may need to begin considering whether to conduct patent searches in connection with any tax planning activity, whether to seek expert advice, and depending on the results, what course of action to pursue in response to a possible patent claim. One prominent practitioner recently told me that a holder of a tax strategy patent obtained the list of all the attendees at a meeting held to consider the area of tax law involved in the patent. The patent holder sent all of the attendees a letter saying that their business activities might be infringing his patent. Some of those who received the letter in fact paid royalties, as the least costly course of action; others went though the burden and expense of asking their lawyers to review the patent to ensure that they were not guilty of any infringement.

Note that these burdens on the tax system are created without regard to whether the patent involves a tax strategy that the IRS would consider abusive. The mere possibility of a relevant tax strategy patent creates the compliance burden. Indeed, if the patenting of tax strategies were to flourish, I would expect that the additional burdens would be greater in connection with tax strategies that may not in fact be novel or non-obvious than they will be for abusive tax strategies. Abusive planning techniques not only constitute a relatively small percentage of all tax planning, but also receive considerable attention from the IRS.

The proliferation of tax strategy patents would also affect professional culture. Historically, the dissemination of tax planning ideas has been open and widespread. Tax lawyers and accountants currently share information and ideas with each other freely. There is an astonishing array and number of meetings, conferences, conventions, and listservs where tax planning ideas are shared. Although the patent system is designed to encourage the dissemination and discussion of ideas and information, many tax lawyers are concerned that the spread of tax strategy patents will have the opposite effect, namely, that those with new ideas or the beginnings of ideas will hesitate to enter into discussion with others. If patents become an important part of the tax landscape, the atmosphere could become more secretive and less cooperative. The tax system as a whole will suffer if, in order to protect their patentable intellectual property, tax professionals are no longer willing to discuss, evaluate, and criticize each other's insights regarding how to comply with the tax system.

B. The Process of Examining Tax Strategy Patents Could be Improved

1. Lessons from other kinds of business method patents.

In order to review the validity under the patent law of applications for tax strategy patents, patent examiners need expertise in software, finance, and tax. They need to understand the conceptual basis of a range of areas of tax—financial products, estate and gift tax, pension and deferred compensation, to name a few where tax strategy patents already exist. Such expertise is difficult to obtain. Few tax lawyers have such broad knowledge in such varied aspects of the tax law. Most of us work very hard just to keep up in developments and changes in the law in our areas of specialization.

Tax strategy patents, like all other patents, must be both novel and non-obvious. For tax strategy patents, as with other patents, examiners look to prior art to deter-

[4] In 2005, the American Intellectual Property Law Association reported that the average patent infringement case as typically costing $650,000 for each party when the amount at risk is less than $1 million and $2 million for each party when the amount at risk is between $1 million and $25 million. Am. Intellectual Prop. Law Ass'n, *Report of the Economic Survey* 22 (2005).

mine novelty and non-obviousness. Identifying prior art in this area is particularly difficult. This is a new arena for patent law, and the traditional source for that determination, the body of pre-existing patents, is not helpful. In the case of tax strategy patents, to decide whether the idea for which the application is made is "new," examiners need to know how to go about doing specialized tax research in non-patent literature and must do such research as quickly and as efficiently as possible, particularly given the severe time constraints they face.[5]

To a large extent, these issues involving the learning curve of the PTO for reviewing tax strategy patents parallel the issues it faced with software, Internet and other business method patents after *State Street Bank.* Solutions found there will apply here as well. In the years following the *State Street Bank* case, which established the validity of business method patents, many business method patents were subject to criticism as being invalid. Soon after *State Street Bank*, the PTO began partnerships and outreach efforts with business method customers, including requests for resources showing prior art and expanding non-patent literature information and data bases.[6] My understanding is that this collaboration has been successful and helped to improve the PTO review process.

The tax community, both public and private, has begun such a partnership with the PTO. I understand, for example, that the IRS recently provided several days of training on tax law to those in the PTO who examine tax strategy patents. Such training should be done regularly. Various associations of tax professionals have begun to study tax strategy patents and would be eager to help as well. For example, there was an overwhelmingly enthusiastic response when I asked tax law professors whether they would be interested in setting up a session to give PTO examiners training in how to do tax research thoroughly and quickly, and I am currently working with the PTO to try to arrange such a session. The PTO and the tax community need to continue to expand such efforts. In addition, the private tax bar needs to educate its members about the existence of tax strategy patents and their impact on tax practice. Such efforts are also underway.

Moreover, I urge various professional organizations to monitor individual applications for tax strategy patents and, as described below, to submit instances of prior art in connection with such applications. I also recommend that these organizations do regular reports on the nature of and issues involving tax strategy patents and patent applications. These reports could, for example, survey the number of such patents, their subject matter, issues involving prior art and non-obviousness as well as issues involving consistency with the tax laws. Such reports would enable the bar and policymakers to understand better the nature and dimension of this issue.

2. Special considerations applicable to tax strategy patents.

Two considerations seem to me to differentiate tax strategy patents from other business method patents. The first implicates the relationship between utility and public policy in the patent law. Under the patent law, a patent must be useful for some valid purpose. The usefulness of a tax strategy patent is likely to turn, at least in part, on interpretation of the tax law. That is, a tax strategy patent may achieve its intended purpose only if a particular interpretation of the tax law is correct or, at least, permissible. The issuance of the patent, however, does not decide the correctness of the legal interpretation. Patents are not a government seal of approval, although they are often seen—and marketed—as such.

Under the patent law, "[t]he threshold of utility is not high: An invention is useful'. . . if it is capable of providing some identifiable benefit."[7] Although Justice Story wrote in the 19th century that inventions "injurious to the well-being, good policy, or sound morals of society" are unpatentable,[8] modern courts have avoided consideration of broad public policy in awarding patents and concluded that "[t]he requirement of utility' in patent law is not a directive to the Patent and Trademark Office or the courts to serve as arbiters of deceptive trade practices."[9] Such policy decisions, the courts have declared, are the duty of other agencies or for Congress itself.[10]

Thus, the tax policy issues embedded in tax strategy patents are for the Treasury and the IRS, not the PTO, to consider. For many years, the Treasury and the IRS have been battling a constant flow of tax shelters and other questionable tax avoid-

[5] I understand from the PTO that the average amount of time for examining a tax strategy patent is 32 hours.

[6] *See* http://www.uspto.gov/web/menu/busmethp/partner.htm*;* Allison and Tiller, *supra* note 1, at 1024–25.

[7] Juicy Whip, Inc. v. Orange Bang, Inc., 185 F.3d 1364, 1366 (Fed. Cir. 1999).

[8] *Id. (quoting* Lowell v. Lewis, 15 F. Case. 1018, 1019 (C.C.D. Mass. 1817)).

[9] Juicy Whip, Inc., 185 F.3d at 1368.

[10] *Id.*

ance schemes. The IRS must be constantly vigilant in identifying new schemes and significant variations on old ones that require fresh IRS scrutiny to determine their validity under the tax laws. Tax patents, although they offer the IRS the advantage of public availability, are likely to make this task even more difficult. Patents carry with them the appearance of federal government approval and the legal presumption of validity. I am concerned that taxpayers and others who consider employing tax strategy patents will rely on the appearance of government approval and the presumption of validity a patent carries and, therefore, fail to evaluate carefully whether the underlying tax strategy actually works. If such is the case, the impact on federal tax revenue could be substantial.

To address such tax-specific concerns, I urge the Treasury and the IRS to consider establishing procedures by which every patent that involves tax strategies interpreting the Internal Revenue Code will be subject to IRS scrutiny as soon as possible, which currently would mean as soon as the patent application or the patent itself is made public on the PTO website. This IRS review would be followed, if needed, by a notice along the lines of notices now published in connection with potentially abusive tax shelter transactions alerting potential investors to possible liabilities if they participate in the transaction. The very existence of such a program by the IRS should discourage the filing of questionable patent applications. Its benefit would, I believe, outweigh the costs to the IRS of establishing such a review. Such a program is crucial to our learning the full scope and potential impact of the phenomenon of tax strategy patents, in particular the extent to which these tax strategy patents involve abusive tax shelters.

The other tax-specific issue relates to procedures for publication of patent applications. Under the patent regulations, a member of the public can submit publications relevant to a pending published patent application within two months of its publication date.[11] Since 2000, patent applications have generally been published within 18 months of their filing. However, a patent application can be kept confidential if the applicant certifies that the same idea will not be the subject of an application filed in another country requiring publication within 18 months after filing. [12] Since inventors generally desire protection of their ideas in other countries, most patent applications are currently made public. I understand that the PTO estimates that approximately 10–15% of all patent applications and a slightly larger percentage of business method patents are kept confidential.[13]

For those tax strategy patents that are kept confidential, the public will be unable to submit to the PTO publications showing prior art, and the IRS will not be able to undertake early consideration of any policy issues implicated in a particular tax strategy patent. Because of the public policy issues involved in tax strategy patents, I urge that the PTO establish special publication rules to give the IRS access to all tax strategy patent applications.

The patent statute allows the Director of the PTO to determine "special circumstances" overriding confidentiality.[14] The patent regulations explain that the PTO, "either sua sponte or on petition, may also provide access or copies of all or part of an application if necessary to carry out an Act of Congress or if warranted by other special circumstances,"[15] and I would argue that such access is necessary to carry out the Internal Revenue Code. If the IRS had access to all applications for tax strategy patents early in the examination process, it could review the tax policy issues raised and prepare any necessary notices regarding the technique as a matter of tax law, as described above, before a tax strategy patent is issued and marketed. Meaningful and ongoing interagency cooperation in this regard is as essential as continuing education in tax developments for PTO examiners in order to monitor this emerging and potentially significant development. Efforts of this Subcommittee and its staff can help to ensure such cooperation.

If the PTO does not believe it has regulatory authority to permit the IRS with early access to tax strategy patent applications, legislation to authorize and direct

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[11] *See* 37 C.F.R. 1.99. Members of the public can also file protests based on prior art against pending applications, *see* 37 C.F.R.1.291, and cite prior art to the PTO during any period of enforcement, *see* 37 C.F.R. 1.502, as well as request reexamination, *see* 35 U.S.C. 302.

[12] 35 U.S.C. 122(b)(2)(B).

[13] Allison and Tiller, supra note 1, at 1049 n. 192, observe that Europe does not recognize business method patents. Nonetheless, applicants may wish to permit the PTO to publish business method patent applications, including tax strategy patent applications, even if they will not seek foreign patent protection, since publishing a patent application offers the advantage of triggering liability for patent infringement as of the date of such application, rather than the date the patent issues. See 35 U.S.C. 154(d).

[14] 35 U.S.C. 122(a).

[15] 37 C.F.R. 1.14(h).

the PTO to do so may be appropriate and desirable.[16] Other more general legislative changes to our patent law already under discussion, such as expanded post-grant opposition that would permit submission of "the common general knowledge of practitioners . . . not fully described in the published literature likely to be consulted by patent examiners," could also be useful in ensuring the quality of tax strategy patents.[17] Proposed legislation applicable to all business method patents would be helpful for the issues raised by tax strategy patents as well.[18]

C. Patent Policy and Tax Policy Differ in Important Ways

The fundamental purpose of providing patents, as I understand it, is to promote innovation. While no one can dispute this as a generally desirable goal, it would be hard to identify a subject less in need of further innovation than tax planning. Existing economic incentives already provide ample inducement for the development, promotion, and implementation of tax planning strategies.

The primary purpose of our tax laws is to raise money for the government and protect the public fisc. Many, perhaps most, tax strategy patents have as their fundamental objective the reduction of federal tax liabilities. While taxpayer efforts to reduce taxes are, of course, permitted and tax advisers spend many hours in such efforts, tax strategy patents seem to me different from such efforts because patents constitute a government-sanctioned monopoly. If tax strategy patents and their use proliferate, encouraged by the marketing advantages conferred by patents' government-granted monopoly and presumption of validity, many tax lawyers anticipate that there will be a corresponding reduction in federal tax revenues, generating revenue losses that would have to be made up from other sources. Granting a government monopoly in the form of a patent that undermines another key federal function—the collection of revenue—seems peculiar, if not contradictory, and raises fundamental questions about the appropriateness of such patents.

Of course, decisions to limit patent protection legislatively should be taken only after much deliberation and study.[19] Experience with the review programs by professional organizations and the IRS suggested above could be enormously helpful in evaluating whether legislation prohibiting tax strategy patents should be enacted. The need for careful deliberation, however, does not rule out the need to consider such an approach. My hope is that this hearing will be the first step in such consideration.

D. Summary and Conclusion

Allow me to summarize the various concerns I have identified. The proliferation of tax strategy patents would change and burden tax practice. Given such an impact, it is important that we act to ensure that the examination process be as accurate as possible, particularly with respect to identifying prior art. The PTO should be provided the necessary resources and training. Professional organizations have a role to play, both in helping to train PTO personnel and in identifying prior art. Given the significance of such patents to the proper administration of the tax law, I have suggested removing any legal obstacles to sharing tax strategy patent applications with the IRS, so that the IRS can review all such patent applications and

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[16] Such legislation would help to guard against tax strategy patents that are novel in ways inconsistent with the tax laws, but would not guard against the grant of patents for which prior art in fact exists. The need for public input on prior art might argue for making all business method patent applications or at least all tax strategy patents applications public in order that members of the public could submit instances of prior art during the examination process, but such a change to the patent law would, I realize, alter substantially the current balance between public access and confidentiality struck by the statute.

[17] Bronwyn H. Half and Dietmar Harhoff, *Post-Grant Reviews in the U.S. Patent System—Design Choices and Expected Impact,* 19 Berkeley Tech. L. J. 1, 13 (2004) (quoting NAt'l Acad. of Sci., A Patent System for the 21st Century (Stephen A. Merrill et al. eds, 2004) at 5. *See* Hearing before the Subcommittee on Courts, the Internet, and Intellectual Property of the Committee of the Judiciary, House of Representatives, on Patent Quality Improvement: Post-Grant Opposition, 108th Congress, 2nd Session, June 24, 2004, Serial No. 91.

[18] *See* Hearing before the Subcommittee on Courts, the Internet, and Intellectual Property of the Committee of the Judiciary, House of Representatives, on The Business Method Patent Improvement Act of 2001, H.R. 1332, 107th Congress, 1st Session, April 4, 2001, Serial No. 5.

[19] For Congressional limitations in connection with patents on particular technologies, such as the provision immunizing physicians, hospitals, and other health care providers for infringement liability for using patented medical procedures, *see* Allison and Tiller, *supra* note 1, at 994 n 19. Congress has enacted some special rules for business method patents. The First Inventor Defense Act of 1999, Pub. L. No. 106–113, 113 Stat. 1536 (codified as amended at 35 U.S.C. 273), creates a special patent-infringement defense if an inventor used a business method in secret and was later sued by a patent holder who had subsequently been granted a patent on the method.

take appropriate and early remedial action where necessary. Cooperation between the IRS and the PTO is essential.

I ask that this Subcommittee continue to monitor tax strategy patents to determine whether they in fact undermine the efficacy of the tax laws and increase tax compliance burdens, as we tax lawyers fear, or, instead, provide additional incentives for innovation and increase openness regarding new ideas, as patent lawyers suggest. Such a determination will be vital to further, informed discussion of whether legislation should be enacted to prohibit or limit sharply tax strategy patents.

In closing, I suggest that this Subcommittee view tax strategy patents not as an instance of the now-established category of business method patents, but as an instance of a potential new category—legal method patents. Tax strategy patents differ from other business method patents in that they depend on the validity of an interpretation of law. If patents are permitted for interpretation of the federal tax laws, creative minds coupled with economic incentive will seek—and obtain—valid patents relating to interpretations of other areas of law, including, for example, litigation strategies. I ask the Subcommittee whether this is a desirable goal for a country based on the rule of law.

Thank you very much. I would be pleased to answer any questions.

Chairman CAMP. Thank you very much. Mr. Belcher.

STATEMENT OF DENNIS I. BELCHER, PARTNER, MCGUIREWOODS, LLP, RICHMOND, VIRGINIA

Mr. BELCHER. Mr. Chairman, Members of the Subcommittee, I want to thank you for bringing this issue to the attention of the public. I come to you as a practitioner with 30 years of experience. I also come to you as an officer in the American College of Trust and Estate Counsel, which is an organization of approximately 2,600 lawyers who specialize in estate planning. We believe that patenting of tax reduction techniques, particularly estate planning techniques or transfer tax reduction techniques, is creating a problem for practitioners but more importantly a problem for taxpayers. We also believe that if this is not addressed early, it will no longer just affect a small group of people, it will affect a larger group of the taxpayers. As we know, right now there are less than 2 percent of the population of the country subject to the transfer tax rules. So, when we see a transfer tax technique being patented, it is serious to our organization and it is serious to our clients but that is less than 2 percent of the population. What we are worried about is if we do not stop this patenting of tax reduction techniques, it is going to spread and affect a larger group of people.

When we first encountered this was in 2003 when a patent was issued that was called a stock option grantor retained annuity trust. It is the SOGRAT patent. When we first discussed it in 2004, everyone that I talked to was shocked that we had to worry about patenting estate planning techniques, particularly this one because Congress in 1994 created a grantor—created the principles by which you could use a grantor retained annuity trust. Then in 1999, a patent was filed that was granted and issued in 2003 that took a grantor retained annuity trust and coupled it with a non-qualified stock option. Practitioners that I deal with have been using grantor retained annuities trusts for years, and using them with a variety of techniques. For example, in my paper I point out that we used agrantor retained annuity trust (GRAT) with a thoroughbred race horse. What you want to use a GRAT with is an asset that will appreciate significantly in value, such as a nonqualified stock option. So, we were surprised when we heard about the patenting of the technique. Similar to what Ms. Tubbs Jones' colleagues told her when she asked them were they worried about it, no, they weren't worried about it. I submit that they should be worried about it because in January of this year, there was a lawsuit filed against an individual who had placed non-qualified stock options into a GRAT, had made a filing with the Securities and Exchange Commission (SEC) because he was a corporate insider, and then that showed up and then he has been sued. If you read the complaint, they leave open who else will be sued. You would think that the representatives who helped put this together will also get sued.

Now, as Mr. Toupin pointed out, lawyers have ethical obligations to point out to their clients the techniques that will be used and the drawbacks to the techniques. At a recent meeting of the American College of Trust and Estate Counsel, we took a poll, if you were advising a client to put non-qualified stock options into a grantor retained annuity trust, would you be obligated to point out the existence of the V patent? Yes, you would. What are the choices that the client will have? Ignore the patent and get sued; don't do a technique that has been governmentally authorized to minimize legally your transfer taxes; or pay a license fee.

For the reasons that are set forth in the paper, we believe that transfer tax reduction techniques, as well as all tax reduction techniques, should not be allowed to be patented. It should be against public policy that when Congress imposes taxes, I have no choice but to pay my taxes. I should be allowed to use the principles that Congress has enacted to allow me to lawfully reduce my taxes. If someone has a patent on it because that person was the first person to get to the Patent Office, then I have got to pay a toll charge, a tariff, to use it or I just ignore it at my peril. Taxes are different than businesses. If there is a patent on a mousetrap, as the Chairman pointed out, I can decide to not use the mousetrap, I can decided to try to do a better mousetrap, or I could get a cat to get the mice, or I can just ignore the mice. With taxes, I cannot do that. So, for the reasons that are set forth in our testimony, we believe that patents on tax reduction techniques should not be allowed. Thank you.

[The prepared statement of Mr. Belcher follows:]

Statement of Dennis I. Belcher, Partner, McGuireWoods LLP, Richmond, Virginia

Chairman Camp and distinguished members of the Subcommittee, I am Dennis I. Belcher, a partner in the Richmond, Virginia office of the law firm McGuireWoods LLP. I have been in the private practice of law for more than thirty years and have spent my career representing clients in estate planning. In my law practice, I advise clients on how to minimize federal and state estate, gift and generation-skipping taxes ("transfer taxes") using estate planning techniques so as to maximize the assets passing to family members and other beneficiaries.

I am currently an officer in the American College of Trust and Estate Counsel ("ACTEC"). ACTEC is a non-profit professional association comprised of approximately 2,600 lawyers who are selected on the basis of professional reputation and ability in the field of trusts and estates and having made substantial contributions to those fields through lecturing, writing, teaching, and bar leadership activities. I am the past Chairman of the American Bar Association's Real Property, Probate and Trust Law Section, which has approximately 30,000 members who are interested in the areas of probate, trust law, and real estate law. I am also a member of a Task Force, called the Patenting Estate Planning Techniques Task Force (the "Task Force"), created by ACTEC in 2005.

I am testifying today on my own behalf and on behalf of ACTEC and the Task Force. My testimony represents my own views, the views of ACTEC and the Task Force, but not those of my firm, any of its clients, or the American Bar Association.

Summary

From my experience and discussions with other estate planning professionals, I believe that:

- Patents for tax reduction strategies in the area of transfer taxation are creating problems for many taxpayers;
- If patents for transfer tax reduction strategies are not prohibited, this type of patent will in all likelihood expand and create problems for more taxpayers; and
- Patents for tax reduction strategies should be prohibited either by the U.S. Patent and Trademark Office or by legislation.

Background

Until 2003, few estate planning advisors[1] gave consideration to patents when advising clients about estate planning. That view changed in 2003 when an individual was awarded a patent for an estate planning technique that the patent holder called a "SOGRAT".[2] (Although the SOGRAT patent was awarded in 2003, anecdotal evidence suggests there are still a significant number of estate planning advisors who are not aware that patents can be awarded for transfer tax reduction techniques.) According to the patent, a SOGRAT involves a grantor retained annuity trust funded with nonqualified stock options. (A grantor retained annuity trust, referred to as a GRAT, is an estate planning technique authorized by Congress, the Treasury Department, and the Internal Revenue Service.[3]) When word of this patent spread through the estate planning community, most estate planning professionals were shocked to learn that an individual could patent a common estate planning technique used in connection with a specific asset, the purpose of which is to allow taxpayers to minimize their federal estate and gift tax liability, particularly a technique authorized under the Regulations issued by the Treasury Department and approved in many Internal Revenue Service rulings.

In response to concerns about the impact of using patents to restrict the availability of commonly used estate planning techniques, such as GRATs, experienced estate planning lawyers discussed the ramifications of such patents at a meeting of ACTEC's Estate and Gift Tax Committee in October 2004. I had the privilege of chairing that meeting. Because of the serious nature of the concerns expressed at this meeting, ACTEC created the Task Force to study this issue[4] Once the existence of the Task Force became generally known to the estate planning community, other professional organizations joined the Task Force. Organizations with members on the Task Force now include the American Bar Association's Real Property, Probate and Trust Law Section, the American Bankers Association, and the AICPA.[5] Members of the Task Force agree about the seriousness to taxpayers of the issues presented by the patenting of estate planning techniques. Although the Task Force has not completed its study or issued findings or a formal report as of this date, the Task Force has authorized me to testify on its behalf. Because ACTEC agrees with the Task Force's concern, on July 8, 2006, ACTEC also authorized me to speak on behalf of ACTEC.

The purposes of my testimony are to (1) inform Congress that a patent of one transfer tax reduction technique, the SOGRAT patent, is presenting significant problems to many taxpayers, and (2) recommend that either the U.S. Patent and Trademark Office or Congress prohibit the patenting of tax reduction strategies be-

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[1] As used in this statement, estate planning advisors and professionals refers to lawyers, accountants, financial planners, and insurance professionals.

[2] Patent No. 6,567,790, Establishing and Managing Grantor Retained Annuity Trusts Funded by Nonqualified Stock Options.

[3] Internal Revenue Code section 2702 and Treasury Regulation section 25.2702–2(a).

[4] In addition to me, members of the Task Force from ACTEC are Louis S. Harrison and William C. Weinsheimer (Chair of the Task Force).

[5] The representatives from the American Bar Association's Real Property, Probate and Trust Law Section include Steve R. Akers, Christine L. Albright, Alan F. Rothschild, Jr. and Michael D. Whitty. The representatives from the American Bankers Association include Kathleen C. Brown, Julianne M. Hallenbeck, and Joseph W. Mooney. The representatives from the AICPA are Evelyn M. Capassakis, Justin Ransome, and Steven A. Thorne. Ellen P. Aprill is a liaison to the Task Force from the American Bar Association's Section of Taxation.

fore the patenting of this type of strategy becomes more widespread and affects more taxpayers.[6]

The SOGRAT Patent

In some instances, Congress, the Internal Revenue Service, and the Treasury Department have authorized tax reduction techniques which taxpayers may take advantage of to reduce their federal tax liability. Examples of government authorized tax reduction techniques in the estate planning area include the federal estate and gift tax marital and charitable deduction, the gift tax annual exclusion, charitable remainder and lead trusts, and GRATs. A GRAT is an irrevocable trust in which the grantor retains an annuity for a fixed term (usually two or more years) and at the end of the term the remaining trust assets pass to beneficiaries selected by the grantor (usually the grantor's family). The grantor transfers assets to the GRAT that the grantor believes will appreciate significantly over the term of the trust. Under Internal Revenue Code section 2702, the Regulations issued by the Treasury Department under section 2702, and rulings issued by the Internal Revenue Service, the grantor is able to deduct for gift tax purposes the value of the grantor's retained annuity, thereby reducing the amount of the gift to the grantor's family.[7] Because of the taxpayer's ability to transfer appreciation on assets in the GRAT to family members at a reduced gift tax cost, the GRAT is a frequently used estate planning technique.

On May 20, 2003, the U.S. Patent and Trademark Office awarded Mr. Robert C. Slane of Wealth Transfer Group, L.L.C. a patent for a GRAT funded with nonqualified stock options, which Mr. Slane calls a SOGRAT (a stock option granter retained annuity trust).[8] The first claim in the SOGRAT patent is:

A method for minimizing transfer tax liability of a grantor for the transfer of the value of nonqualified stock options to a family member grantee, the stock options having a stated exercise price and a stated period of exercise, the method performed at least in part within a signal processing device and comprising:

Establishing a Grantor Retained Annuity Trust (GRAT);

Funding said GRAT with assets comprising stock options,

The stock options have a determined value at the time the transfer is made;

Setting a term for said GRAT and a schedule and amount of annuity payments to be made from said GRAT; and

Performing a valuation of the stock options as each annuity payment is made and determining the number of stock options to include in the annuity payment.

Problems Created by the SOGRAT Patent

The existence of the SOGRAT patent is preventing taxpayers from using a government authorized estate and gift tax reduction technique, thereby presenting problems to taxpayers in planning their affairs. During one of the Task Force discussions, one Task Force member reported that the holder of an estate planning patent recently contacted an estate planning advisor employed by a financial institution and informed the advisor that the patent holder was the owner of the estate planning technique suggested by the advisor in a newsletter to clients. The advisor sought legal guidance on the proper course of action. Notwithstanding that the advisor's lawyer believed the patent may be invalid, the lawyer recommended that the advisor not risk using the patented technique without permission of the patent holder. The lawyer gave this advice presumably because of the high cost of defending a patent infringement law suit or prosecuting a suit to invalidate the patent. After discussions, the advisor agreed not to suggest the use of the legally authorized estate planning technique in connection with a particular type of asset without informing clients and their lawyers of the existence of the patent so that the client and lawyer would be responsible to make their own judgments about the validity of the patent and the degree to which it needed to be honored.

There is a lawsuit pending against a taxpayer alleging the infringement of the SOGRAT patent. On January 6, 2006, the SOGRAT patent holder filed suit in the Connecticut United States Federal District Court for infringement of the SOGRAT patent. The defendant in the lawsuit is Dr. John W. Rowe, the Executive Chairman of Aetna, Inc. The lawsuit is in the discovery stage and is anticipated to go to trial

[6] The U.S. Patent and Trademark Office classifies patents dealing with tax reduction techniques as subclass 36T in Class 705. According to the Patent Office's website, 48 patents have been issued in that subclass and there are 81 patent applications are pending.

[7] An the article by Robert L. Moshman, "Good GRATs and Great GRATs—And An Interview With Robert C. Slane," *The Estate Analyst*, April, 2006, the author stated: "Despite cracking down on estate-freezing techniques, Chapter 14 provided a beautiful safe harbor. The grantor retained annuity trust, better known as GRAT, is explicitly authorized under section 2702."

[8] Patent No. US 6,567,790.

in 2007. Because I understand that the lawsuit is being prosecuted vigorously, the lawsuit cannot be considered a nuisance lawsuit. When this lawsuit was discussed at ACTEC's Estate and Gift Tax Committee on July 8, 2006, the vast majority of lawyers present (more than 100 experienced estate planning lawyers) indicated that they would not recommend to any client the use of a GRAT funded with non-qualified stock options without disclosing the existence of the SOGRAT patent and the pending lawsuit. In addition, these lawyers indicated that they would be reluctant to allow a client to use this technique without the permission of the patent holder.

Because I am not trained in intellectual property law, I cannot comment on the validity or non-validity of the SOGRAT patent. But, I am qualified to address the taxpayer problems created by patenting estate tax reduction techniques because of my thirty years' experience in representing taxpayers. Like most experienced practitioners, I am troubled by the SOGRAT patent for several reasons. First, an individual has been allowed to privatize a tax reduction technique authorized by the United States government. Second, because GRATs can be and are used for any type of asset[9], there is nothing unique about coupling a GRAT with nonqualified stock options. Because nonqualified stock options have desirable features affecting the valuation of the options for transfer tax purposes, the use of nonqualified stock options in a GRAT may be considered rather obvious. In summary, the SOGRAT patent is creating problems with taxpayers because of the chilling effect on the use of this authorized technique.

Patenting of Transfer Tax Reduction Techniques Should Be Prohibited

Because patents of transfer tax reduction techniques present problems to many taxpayers, the U.S. Patent and Trademark Office or Congress should prohibit these types of patents for the following reasons:

1. It should be against public policy for a private individual to patent a technique used to reduce a taxpayer's tax burden;
2. Patenting estate planning techniques unfairly increases a taxpayer's costs or the federal estate and gift taxes payable by the taxpayer if patented techniques are not used; and
3. Because a patent on a tax planning technique can add credibility to the technique, patents on objectionable or aggressive tax planning techniques can hurt compliance with the federal tax laws.

It is not the function of the Internal Revenue Service or the Treasury Department to curtail patents of tax planning techniques. Because of the nature of transfer tax reduction techniques, it may not be possible for the U.S. Patent and Trademark Office to make an adequate review of these techniques. Accordingly, a legislative solution may be the appropriate response to protect taxpayers and to curtail the patenting of all tax planning techniques before these patents become more widespread.

1. It should be against public policy for a private individual to patent a technique used to reduce a taxpayer's tax burden.

A patent of a tax reduction technique is unlike other business method patents because it relates to taxes. If there is a business method patent in a particular area of business, a citizen has the choice to either pay for the right to use the technique, to engage in that business activity in a different way, or not to engage in that business activity at all. A taxpayer who complies with the tax laws does not have that choice—the taxpayer must pay his or her tax burden. In the familiar of words of Judge Learned Hand, however, "Any 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."[10] It should be against public policy to allow a patent of a tax reduction technique because the patent prevents taxpayers from exercising their right to minimize their taxes within the limits of the law, and avoiding the activity in question, the payment of taxes, is not an option.

In addition, patenting tax reduction techniques allows private individuals to leverage the federal tax system thereby imposing an additional cost on taxpayers. As the tax rates vary, the value of a tax reduction technique patent will vary accordingly. Because a taxpayer pays the patent holder for the right to use a tax reduction technique to reduce the taxpayer's tax burden, the patent holder is in effect imposing a tax in the form of a toll charge on the use of the technique.

There are a small but growing number of patents in the tax reduction area. If patenting tax reduction techniques is not stopped, the practice will spread to other

[9] Estate planning lawyers in my law firm have used GRATs for many different types of assets, including real estate, marketable securities, stock in private businesses, and thoroughbred race horses.

[10] *Helvering v. Gregory*, 69 F.2d 809, 810–11 (2d Cir. 1934).

areas of the tax law and affect more taxpayers. Although GRATs are used only by those taxpayers subject to the federal estate tax, there may be a rush to the U.S. Patent and Trademark Office when Congress passes the next tax bill with a new tax minimization provision. The first individual to file a patent should not be rewarded at the expense of those taxpayers trying legitimately to minimize their tax burdens. Consider the result if an individual had patented the transfer of appreciated securities to a charitable remainder trust, a technique similar in many ways to a GRAT, when Congress first allowed these types of trusts in 1969.[11] Because a patent holder cannot be compelled to grant a license for a patent, a patent holder could have precluded any taxpayer from using a charitable remainder trust, which was a congressionally authorized tax reduction technique, to the detriment of taxpayers and charity. Clearly, this is not in the best interest of the public and should be against public policy.

Patents on tax reduction techniques are different from other business method patents. Because patents of tax reduction techniques prevent taxpayers from minimizing a burden imposed by law and affecting all taxpayers, it should be against public policy to allow patenting of tax reduction techniques. Thus, either the U.S. Patent and Trademark Office or Congress should prohibit patents on tax reduction techniques.

2. Patenting estate planning techniques unfairly increases a taxpayer's costs and federal estate and gift taxes.

Because taxpayers will have to pay a fee to use an estate planning technique authorized by law, many taxpayers will be forced to pay more in an effort legally to minimize their federal taxes. Before an estate planning advisor recommends that a client use a patented estate planning technique, the advisor has an obligation to point out the options and risks to the client of using a patented technique. When a client is considering the use of a patented estate planning technique, the client has these options: (a) file a lawsuit to invalidate the patent; (b) ignore the existence of the patent in the hopes that the patent holder will not discover its use; or (c) pay a licensing fee to the patent holder for the use of the technique. Because filing a lawsuit to invalidate the patent is expensive, filing a lawsuit is not a viable option.[12] If the client ignores the existence of the patent in the hopes that the patent holder will not discover its use, the risks to the client can be considerable and can include paying treble damages to the patent holder.

Patenting estate planning techniques unfairly increases the federal estate and gift tax liability of taxpayers. Some taxpayers will refuse to pay tribute to the holder of an estate planning patent. These taxpayers will be forced either to pay more than their fair share of federal estate and gift taxes or risk being sued for the unauthorized use of a patented technique. If the taxpayer refuses to pay tribute and does not want to take the risk of unauthorized use of the estate planning technique, the taxpayer will be forced to forgo the use of an estate planning technique authorized by law. Because the taxpayer will not be allowed to use this technique, the taxpayer will pay more than the taxpayer's fair share of federal estate and gift taxes.

Under the ABA Model Rules of Professional Conduct (the "Model Rules"), a lawyer has a duty to explain issues that are likely to result in adverse legal consequences to the client.[13] Thus, an estate planning lawyer may have an ethical duty to learn about the existence of patents affecting estate planning and inform clients of existing patents on estate planning techniques sought to be used by the lawyer's clients.[14] Under the Model Rules, lawyers must give candid and competent advice using any "legal knowledge, skill, thoroughness and preparation [which is] reasonably necessary."[15] A lawyer must explain a client's options to "the extent reasonably necessary to permit the client to make an informed decision" on a course of action.[16] Because of the possibility of adverse legal consequences to a client from the unauthorized use of a patented estate planning technique, a lawyer may have a duty to (i) determine the existence of any patent on an estate planning technique under consideration, (ii) inform the client of the existence of all patents, and (iii) advise the client of the possible adverse consequences of using the technique without the consent of the patent holder.

By allowing a patent on a transfer tax reduction technique, a taxpayer will either have to obtain the permission of the patent holder to use the technique (presumably

[11] Internal Revenue Code section 664.

[12] According to one source, a suit to invalidate a patent may cost in excess of $1,000,000. *See*, "Patenting Tax Strategies," *Trusts and Estates* Magazine, March 2004, page 44.

[13] Model Rules R. 1.4(b), 2.1 cmt.

[14] *See* Model Rules of Prof'l Conduct R. 1.1, 1.4, 2.1 (1983).

[15] Model Rules R. 1.1, 2.1

[16] Model Rules R. 1.4.

for the payment of a fee) or have to forgo the use of the technique. Thus, patented transfer tax reduction techniques impose an additional tariff for those taxpayers who want to use legally authorized estate planning techniques to reduce their federal estate and gift taxes.

Because patents on aggressive tax planning techniques add credibility to an objectionable or aggressive technique, patents on tax planning techniques can hurt compliance with the federal tax laws.

Placing what many taxpayers may interpret as a seal of approval from the U. S. Patent and Trademark Office on an aggressive tax planning technique could mislead taxpayers as to the legality of the tax planning technique. Some taxpayers will believe that because a United States government agency has approved the technique, the technique must be a lawful and appropriate technique. Because a patent on an aggressive tax planning technique can add undeserved credibility to that technique, patents on tax planning techniques can hurt the enforcement of the federal tax laws.

Possible Solutions

ACTEC and the Task Force have struggled with the appropriate solution to protect taxpayers from patents on transfer tax reduction techniques, particularly techniques authorized by law. Because ACTEC and the Task Force are not experts in intellectual property, we are reluctant to make recommendations. But, we will offer some observations. We see the following options to address this problem: (a) the Internal Revenue Service could curtail the use of tax planning technique patents; (b) the U.S. Patent and Trademark Office could curtail the use of tax planning technique patents; and (c) Congress could provide a legislative solution.

Because it is not the function of the Internal Revenue Service to curtail patents of transfer tax reduction techniques, we do not believe that enforcement by the Internal Revenue Service is the appropriate solution. ACTEC and the Task Force are concerned about relying on the U.S. Patent and Trademark Office to curtail or eliminate the patenting of tax reduction techniques, particularly transfer tax reduction techniques. If a patent examiner is not familiar with estate planning techniques, it will be difficult for the examiner to determine whether a patent should be awarded for a particular tax technique for several reasons. Presumably, patent examiners are generally not familiar with researching tax law and are not experienced in making the judgments that compliance with tax law requires.[17] Many lawyers, accountants, and financial planners give estate planning advice and do not publish their techniques but discuss these techniques in numerous meetings of professionals. For example, ACTEC's Estate and Gift Tax Committee meets three times annually, discusses many estate planning techniques, but only produces summary minutes of the meetings. Other estate planning professional organizations operate similarly. It is possible that an estate planning technique will be discussed and will have widespread use, but a patent examiner would not have knowledge of the prior use of the technique and mistakenly award a patent for the technique. Although an individual could challenge the patent on the basis of prior work, one individual would not have a sufficient interest in the technique to invest legal fees to challenge the validity of the patent.

If the U.S. Patent and Trademark Office cannot prevent patents of tax reduction techniques, we hope that Congress will find that patenting tax reduction techniques is against public policy and pass legislation preventing these types of patents.

Conclusion

ACTEC and the Task Force on Patenting Estate Planning Techniques believe that patenting transfer tax reduction techniques is creating problems for many taxpayers. If patents for tax reduction strategies are not prohibited, this type of patent will in all likelihood expand and create problems for more taxpayers. We ask that patents for transfer tax reduction be prohibited either by the U.S. Patent and Trademark Office or by legislation.

In closing, I thank the Subcommittee and its staff for allowing me to give you my views on this topic.

[17] ACTEC has volunteered to work with the U.S. Patent and Trademark Office to educate patent examiners on how to research estate planning techniques so as to determine the existence of prior work.

Chairman CAMP. Thank you and thank you all for your testimony. I think you have all raised many good points. My question is, and I guess all of you can chime in, Ms. Aprill, you stopped short of saying that we should not allow tax strategy patents. What do you think about just not allowing tax strategy patents?

Ms. APRILL. We would have to draw some hard lines. We still want the kind of patents that help you file your tax return. We have drawn other hard lines before, and I think it is something we need to consider while making to make sure it doesn't have untoward effects. I certainly wouldn't rule it out. This reminds me of the issues we have with the business purpose test in the tax law. We want taxpayers to have purposes other than tax to do certain transactions, not simply to tax savings but their financial savings as well. We would have to decide how we could draw the line here. If we could draw a good line, I would be very happy. I just wouldn't want to be confident that we have drawn a good line.

Chairman CAMP. Mr. Belcher, you mentioned the case of the lawsuit, yes, I have some trouble with the notice aspect. I realize the patent is a public filing but, as you go to the website, and you read the one sentence summary, it doesn't necessarily give you any indication of what the patent might really be about. Is there a best way to put taxpayers and tax preparers and advisers on notice that a particular tax method is restricted through the patent process?

Mr. BELCHER. Well, Mr. Chairman, you raise a very good point because I submit until this hearing that very few practitioners worried about patents on tax techniques. So, I think that the notice is going to be well-received in the public and they are going to be worried about it. Also, I worry as my obligation to my client is to advise a client on techniques. Every morning, I receive a publication from the IRS where I see the latest rulings and the latest announcement from the Internal Revenue Service. So, when I have meetings that day, I am up to date on what is going on. Will I be required to subscribe to a service or something or go on the Patent Office website and look at every technique, and not just look at the one blurb summary, which is very difficult to determine what it is, but to actually have someone go in and look at the file. So, I think it is going to be a serious problem. You have got several approaches to that. You could have a government agency issue a notice of what a tax technique is, but I am not sure that that is a workable solution. So, I see notice as a real problem for taxpayers.

Chairman CAMP. I think I understand your testimony, you draw a distinction as well between a process of maybe a computer program versus the actual sort of legal or tax strategy of compliance?

Mr. BELCHER. This Subcommittee and the House Committee on Ways and Means draw lines all the time, and they don't make everybody happy where they draw the lines but they do draw the lines. I think, I could see a good logic to drawing a line between a method to compute taxes or to manage taxes versus a technique to reduce taxes. I find it personally offensive that Congress gives us principles that allow me to encourage my clients to reduce their taxes and then I have to pay somebody or a client has to pay somebody, the patent holder, to take advantage of the technique that Congress has provided.

Chairman CAMP. Yes, that is the point I made to the other panel, which was it is obligatory to comply with our tax law and then you have to pay a royalty to do that in certain ways. I have a problem with that whole thing which I think you are sort of underscoring as well. All right, thank you. The Ranking Member, Ms. Tubbs Jones from Ohio, may inquire.

Ms. TUBBS JONES. Thank you, Mr. Chairman. I missed your testimony, but I have been reading last evening and a couple of days before. My question to Mr. Belcher is—Mr. Belcher, how many clients have you had that you have been required to pay a royalty, if you are permitted to tell me without disclosing any confidential information, for use of a patented tax whatever the heck it is?

Mr. BELCHER. None but, as I pointed out earlier, what I worry about are two aspects of this. First, there is a lawsuit pending against an individual who used a grantor retained annuity trust, which was authorized by principles announced by Congress and by the Internal Revenue Service through numerous rulings, and if you read that complaint, it is against the person, the taxpayer who created the trust. If you read that complaint, it states there may be others who participated in that. So, as a lawyer, I worry about my liability for doing that. Now, my choices are——

Ms. TUBBS JONES. Okay, as a lawyer and judge—I don't have a lot of time so make your answer short.

Mr. BELCHER. Yes, ma'am.

Ms. TUBBS JONES. Go ahead, finish.

Mr. BELCHER. What I worry about is the spread of the patenting. It is just affecting a limited number of people now. In the future, it could affect a lot more.

Ms. TUBBS JONES. Good lawyers are able to argue the other person's side. Tell me if you are stepping in the shoes of the lawyers who was helping his client obtain a patent, what would your argument be to me in favor of these?

Mr. BELCHER. That I have been very fortunate to take a advantage of an area where the law is unclear and able to extract fees.

Ms. TUBBS JONES. Sure, Mr. Gruner, yes, sure?

Mr. GRUNER. I might answer that question. I think the case here for individual clients or for the system as a whole is that the availability of these patentsincents the very best people who are capable of non-obvious insights on how to extend tax planning methods, incents those people to pay attention to these problems and to invest substantial time in the development of new methods and then to disclose the results, none of which may happen in the absence of these patent incentives, that even if you get the best people to work on them, they are going to devote that method to the clients of one firm, which is not then going to be available to the public generally.

Ms. TUBBS JONES. So, your argument is that by patenting it, we at least open it to the rest of the world?

Mr. GRUNER. We bring forward new techniques that might not occur at all and then as to those incremental techniques, we bring them to the world. So, it is two things.

Ms. TUBBS JONES. Can I limit the royalties?

Mr. GRUNER. Well, the royalty is only as much as that method advantages you. You are not going to pay for a method that only advantages you a small amount over other alternative methods.

Ms. TUBBS JONES. So, I get to use it, I get to take a look at it, apply it to my cost or my tax situation, and then if I don't use it, I don't pay a royalty?

Mr. GRUNER. Exactly, you only pay a royalty up to the amount that it looks good to you.

Ms. TUBBS JONES. How much is a general royalty, to your knowledge? Anybody know what the royalty is?

Mr. GRUNER. I am not aware of how these particular patents are being licensed but it would be limited by how much the taxpayer perceived the method as being advantageous.

Ms. TUBBS JONES. Ms. Aprill?

Ms. APRILL. Which question would you like me to answer?

Ms. TUBBS JONES. Any of them or just tell me whatever you want to say.

Ms. APRILL. My concern is that we have a lot of these being granted that I think are not obvious and not actually novel. My understanding of other areas of business method patents is that the area where the PTO granted them got narrowed in part through legislation, very, very expensive legislation carried on by very, very big corporations. Given the fact that we are talking about individuals and estate planning at the moment, we might not have the same incentives in the system to get the law developed in the way we need to in order to make sure that we only encourage innovation and not discourage compliance.

Ms. TUBBS JONES. Well, then you are suggesting that the Congress, that we need to go back and re-think or re-look at that legislation that allowed these things to develop?

Ms. APRILL. Others have tried but I would urge you to do it again.

Ms. TUBBS JONES. Okay. Let me say for the record, as I said earlier, I have been talking to my tax friends, tax lawyer friends, and patent lawyer friends, and they were saying, "Huh?" So, I faxed this information out all over the world to my colleagues and friends, and I am interested to see what they have to say when it comes back. Personally, I think we could spend our time better on tax policy other than this because there are a lot of other issues that would benefit the greater good than this particular policy, and I have some real concerns. Thank you.

Chairman CAMP. Thank you very much. Mr. Foley may inquire.

Mr. FOLEY. I share that same concern, and I have got friends who have great ideas and they are waiting for patents to take place to protect their ingenuity. The Patent Office is working on one I think is an abstract area of law, which troubles me. I would rather them work on the technology and innovation side and put their people protecting patent rights rather than in this ambiguous area. I am really troubled because, I think as Mr. Belcher said, if I read the Wall Street Journal today and see some tax policy, think of my client, I am just reading part of it, I don't have a chance to do the whole article, so I don't catch the part that says this is a patented protected tax strategy. I just merely see tax protection, blah, blah. So, I go to the—wow, that applies to my case, that is interesting.

Let me run the numbers. I go do my work. I think I can save my clients quite a bit. That is a very creative and it is in the Code, it is allowable. It has been tested. I am going to recommend it. So, the question to you, 6 months later, he gets a notice to appear or a lawsuit that he has used somebody's technique.

Now that seems troubling to me, that what is out there in the common universe—think about it, Google is now a verb, to Google is to search. Ultimately at the end of the day, it is still a search engine. So, if America Online (AOL) has a search engine or any other computer has a search engine, that no longer should be rendered un-useable because Google has created a brand name. Everybody still should be able to search because they have created a proprietary software or system gives them the right to perfect that system and market that system, and they have done a very good job of it. That shouldn't prohibit anyone else downstream from saying, "I want to create a search engine too.

I am going to call it something else but it will function all the same. It may not be as successful, but I am going to do it." So, I really do have trouble with establishing patents on things that would normally be as a result of sheer reading the tax code and saying if I maintain this schedule of assets based on this date and hold assets until that date. I am either eligible for capital gains or treatment, short- or long-term, that is not too complicated. Some of these other areas you talk about are when you are talking about trusts and estates and meshing of assets. Yes, that is an interesting formulation and one that probably deserves a little bit more thought. What creates that novel idea, if it is allowed by the Tax Code, then why is it patentable for an outside vendor to say—different for software, if I create a program by which you can create this opportunity, I have a right to pursue my patent, but I don't think the methodology should necessarily be. Yes?

Mr. GRUNER. I just wanted to draw a comparison to other areas where the law defines required conduct and then the patent system works within that required conduct. For example, in the environmental area, the product safety area, the law requires certain conduct to be maintained and then a whole bunch of patented methods are devices are used to adhere to that conduct. We have no hesitancy in encouraging innovation in those conduct details through the patent system in those kind of settings. It seems to me that what is going on here is essentially the same thing, people may be incented to work out inner details of how to comply with the Tax Code in innovative ways through the incentives o the patent system.

Mr. FOLEY. Give me one area where it would innovative, that would be so different than anyone else who has the technology, the capabilities to sit down—how could it change the outcome is the law is specific?

Mr. GRUNER. Well, I think the types of patents that are coming forward are indicative of the direction, I don't want to try to defend the particular patents that have been issued because some of them may be just obvious extensions. If one came up with estate planning management technique that was highly intricate, highly computer managed, and which at the end of the process you define what kind of estate transfers were occurring and then apply the appropriate tax result and tax rule and got to the appropriate result, that kind of innovation as to how estates were managed would be a sort of innovation that might not occur, and the implementation be a complex computer technology, might not occur absent these kind of incentives.

Mr. FOLEY. Then, I would apply for a patent on my software because it is truly a software platform.

Mr. GRUNER. Well, it is going to be a mixture. The method would include some software steps and that is what these patents generally are.

Mr. FOLEY. So, you are saying there is a duality there.

Mr. GRUNER. Yes.

Mr. FOLEY. They are both a system as well as an idea.

Mr. GRUNER. Typically, because it is the computer stuff that makes them new, if at all, in other words, that is where they are arguing their new extension lays and therefore their grounds for patenting.

Mr. FOLEY. Well, I seem to be hearing two different things. I heard about a technology, which is what I believe should have a right to patent protection, and a technique that is used simply by taking tax law and using it to its best opportunity.

Mr. GRUNER. I think the distinction that was trying to be made there was between administrative efficiency, programs that might allow a taxpayer to account for their assets and income more efficiently but didn't change the ultimate result under the Tax Code versus conduct-oriented software, for example, managing estate in a certain way, that did in fact reduce the taxes that were paid. These patents cover both those kinds of technologies.

Mr. FOLEY. If I could just, Mr. Chairman, I know my time is up, but it still invokes some double jeopardy for the tax preparer who has the same concept and idea, hasn't impinged on this patent, simply using his knowledge and expertise and coming up with the same result is subject to potential lawsuit.

Mr. GRUNER. It is going to be a problem because many of these methods have been used in secret for some time. That same problem arose in the software industry when software techniques, which had been used in private company environments, were then patented by other parties, and indeed that type of problem led to the prior user defense we see as to certain business methods.

Ms. TUBBS JONES. Just a quick question in that line, Mr. Chairman, thank you. Prior to 1988 and these different products being patented, lawyers were as smart and as innovative and as intelligent and on and on, and on, and nobody contemplated that this would be a patentable subject. Or maybe they contemplated and said, the hell with that, that is crazy, that just is not going to happen or did they?

Mr. GRUNER. Well, in general the whole business method area was thought to be outside the patent system until the State Street decision confirmed the opposite. So, although people might have thought vaguely about patents, they thought that the law was against them. The State Street decision clearly stated that financial methods and now tax planning methods and other business methods, other advantageous business practices are patentable. Now, we are still looking for new——

Ms. TUBBS JONES. I can characterize those judges, as some my colleagues do, judges making law, right?

Mr. GRUNER. No.

Ms. TUBBS JONES. Go ahead.

Mr. GRUNER. Indeed, they were following the law as they understood it, and many commentators thought the same.

Ms. TUBBS JONES. You didn't get that but it is okay.

Mr. GRUNER. I got it.

Ms. TUBBS JONES. Go ahead, I am sorry.

Mr. GRUNER. Many commentators thought that was the law as well, hence, clients didn't seek patents or innovators didn't seek patents in this area, which now leads to part of our problem. We don't have a patent record of past innovations that would now inform current patent issuance decisions.

Ms. TUBBS JONES. Thanks, Mr. Chairman.

Chairman CAMP. Thank you and the gentlewoman from Pennsylvania may inquire.

Ms. HART. Thank you, Mr. Chairman. This just gets more interesting and more interesting as time goes by. I said to my LD as I walked out of the room to take a call, the things that Mr. Belcher said were exactly what I was thinking. So, with that having been said, I have a question regarding I guess public policy issues. The Patent and Trademark Office is looking at an application. Is there some kind of public policy bar that would lock them from issuing a patent for something that they would just, without checking with the IRS, but they still would know would be illegal or have some inclination to believe would be an illegal scheme? Is there something out there now that you would use?

Mr. GRUNER. The issue would be one of utility. An advance has to have practical utility to be patentable. So, if it were purely illegal, presumably its consequences are negative and has no utility. The problem though for the Patent Office is they don't know that with any firm clarity.

Ms. HART. Right.

Mr. GRUNER. Therefore, they are loathe to make that call as a matter of patent issuance.

Ms. HART. So, there is no burden really on them to do that?

Mr. GRUNER. They are unlikely to find out.

Ms. HART. Until later, after they have put a lot work in. I am sorry, Ms. Aprill?

Ms. APRILL. Many of these are not going to be clearly illegal. They are not going to be something that specifically violates the current law or that the IRS has said you do this particular thing and we say it doesn't work under the tax law. They are going to be gray areas.

Ms. HART. It is like the whole area, the gray area, I think. Okay. How about the compliance burden challenge? Mr. Belcher, in your testimony you mentioned that you have a bunch of choices you are going to have to make with a client as far as compliance. Are you going to have to do a patent search every time you try to do estate planning for your client?

Mr. BELCHER. I think to carry out my ethical obligation to my client, I am going to have to be aware of whether there is a patent on a technique that I am using or recommending to the client so the client can make the choice of trying to get a license or a royalty to paying a royalty to use that. So, I think it will be a serious compliance burden.

Ms. HART. Okay, and just a general question for all three of you. I was a private practice lawyer for 13 years and sitting in a room with a client, trying to do the best for them that I could possibly do, every plan is different so you are going to come up with something different for every client and you are going to have this challenge then with basically every client.

Mr. BELCHER. Yes, and the problem with the patents is that they will have multiple different patent claims. So, you will have to establish—you are going to have to worry about whether you are violating any of those patent claims. The problem that with business methods you will have, as Ms. Aprill said, you will have litigation that will establish the parameters because you will have big corporations going after it.

Ms. HART. Yes.

Mr. BELCHER. When you have got just taxpayers, a taxpayer hears that there is a potential issue, the taxpayer is going to say, "Well, I am not going to use it because I am not going to take the risk."

Ms. HART. Right. Go ahead.

Mr. BELCHER. So, it will be the uninformed who will end up being hurt by this.

Ms. HART. In a lot of ways, I represent a lot of small towns and small business people and small family businesses and that sort of thing, they are going to probably be the most at risk if someone decides to go after them.

Mr. BELCHER. If the patent of tax reduction techniques continue, it is accurate that right now it is not a major problem because less than 2 percent of the people are faced with transfer tax issues, but once it moves in in greater threat in the income tax area—I will give you the one example that we thought about is a charitable remainder trust that Congress created in 1969. Let's assume that I go down to the patent office and I patent a charitable remainder trust funded with multiple securities. Well, obviously, Congress has allowed charitable remainder trusts for a lot of different policy reasons. Well, I now control it. Sure, I can license it or I can decide not to license it at all. I am just going to keep it, and I am just going to let my friends use it. Who is going to challenge that? There is not one taxpayer who will have enough interest, economic interest to challenge these. What we have been told is that the cost of challenging a patent may exceed $1 million.

Ms. HART. I am concerned about us, and I will just stop, my goal obviously here is to make sure that we are not restricting what would be sort of a natural response to a taxpayer doing what he or she is supposed to do to comply with the law. In some ways it seems like we are doing that. As a matter of policy, would any of the three of you suggest that we should put forth some restrictions as to what types of things should be exempted from patent or is that sort of too esoteric a question?

Mr. BELCHER. Personally, I think that any tax reduction technique should not be patentable period. Because that prohibits, that prevents access to minimizing your taxes through lawful techniques or lawful principles announced by Congress. When you get into methods or calculations or assistance in managing assets, I think that Richard is exactly right. I don't see any problem with patenting that.

Ms. HART. There is software and there is some specific—did you want to expand on that a little bit?

Chairman CAMP. The gentlewoman's time has expired.

Ms. HART. Oh, I am sorry.

Chairman CAMP. Mr. Gruner, if you want to answer briefly.

Ms. HART. The red light is not facing me.

Mr. GRUNER. Quickly, on the level of whether we need to change the law to exclude certain types of patents, I think the law is correct as it stands, the law says only non-obvious extensions should be patentable. What we need is a better definition of what is the obvious technique and capability in the tax planning field so that matters within that range of normal expansion, day to day effort of tax specialist lawyers is not being patented because the record of skills and range of those non-patentable inventions is correctly documented and available to the Patent Office.

Ms. HART. Okay, so there is actually a line we could find.

Mr. GRUNER. It currently includes that line, we just need more information to better implement.

Ms. HART. Okay, thank you. Thank you for your indulgence, Mr. Chairman.

Chairman CAMP. Thank you. I guess just to sum up, my question for each of you, I would like you just to respond briefly, is we have heard this about drawing a line between methods and strategies, and in your opinion, each of your opinions, could you answer whether or not you think that it is possible legislatively, you are the experts in this field, to draw the line for tax strategy purposes, the line between methods and strategies?

Mr. GRUNER. Well, I think that the two are going to blur together. If the question goes to the notion of could we define a tax method exception to the patent law, it would be, I think, quite difficult because of the blurring between financial advantage generally and tax advantage specifically unless we were to exclude financial methods entirely from the patent laws, which would be a dramatic change after the State Street opinion. So, I think it would be quite difficult to separate tax planning strategies from financial methods more generally.

Chairman CAMP. All right, Ms. Aprill, do you have an opinion?

Ms. APRILL. I think it would be difficult. I think we should try but because it was difficult. I suggested another way of going to protect individual taxpayers in their individual capacity and small businesses, in order to avoid some of the difficult line drawing.

Chairman CAMP. All right, Mr. Belcher?

Mr. BELCHER. I think there are a lot of bright people who can draw those lines and so I think you can.

Chairman CAMP. Well, thank you and thank you all——

Ms. TUBBS JONES. One more quick question?

Chairman CAMP. Yes, yes.

Ms. TUBBS JONES. Thank you, Mr. Chairman. Assuming all we have discussed, I am curious whether you think down the line all these bright and intelligent lawyers will then be seeking a patent on legal advice for picking a jury, setting up the insanity defense, all kind of other things that go on in the course of a trial? I see some frowns being made back there but—real stunned, but I am stunned.

Mr. BELCHER. What is to prevent it?

Ms. APRILL. Indeed, when I talk to a lot of patent people when I was working on this and several of the patent professors said to me, "We have been worrying for years about legal method patents, and I want you to think about this not as a form of business method pattern but a form of legal method patent."

Chairman CAMP. Mr. Gruner?

Mr. GRUNER. Well, let me just say that it is not as scary as that suggests because the techniques used in the courtroom and legal practice generally are the common techniques. That is the methodology that is already known.

Ms. TUBBS JONES. Lawyers don't think they are common but go ahead.

Mr. GRUNER. Those are not going to be non-obvious methods if in fact the skills that lawyers have used for years to pick a jury are brought forth as a possible patent.

Ms. TUBBS JONES. Are you a trial lawyer?

Mr. GRUNER. I'm sorry?

Ms. TUBBS JONES. Are you a trial lawyer?

Mr. GRUNER. No.

Ms. TUBBS JONES. I thought so.

Chairman CAMP. All right, thank you. Any other questions? I want to thank the panel. This was an excellent hearing, and very much appreciate all of your effort and testimony. Thank you very much. This hearing is now adjourned.

[Whereupon, at 12:05 p.m., the Subcommittee was adjourned.]

[Questions From Ms. Tubbs Jones to Mr. Toupin follow:]

Question: Of all of the tax patents that have been issued to date, how many have generated fees or profits under a licensing agreement for the patent holder? Is the motive behind seeking a patent to generate a profit or simply to protect one's "invention"?

Answer: We are unable to respond to the first question because the USPTO does not require, request or compile information regarding the amount of fees or profits received by any particular patent owner or category of owners under licensing agreements.While the motive or motives behind seeking a patent vary among inventors, generating a profit and protecting one's invention are certainly primary motivating factors.

Question: To your knowledge, how many of the patents that have been issued are being "marketed" by the patent holder? That is, how many of the tax strategies that have received patents do you know are being "shopped around" to taxpayers?

Answer: We are unable to respond to these questions because the USPTO does not require, request or compile information as to whether a particular patented invention is "marketed" or the nature or extent of commercialization, if any, of a patented invention.

Question: If taxpayers are believing that a particular tax strategy has some sort of "seal of approval" because it has been patented, then should the IRS not be intimately involved in the process of issuing tax patents? To what extent is the IRS currently involved?

Answer: Current patent law governing the USPTO's authority and operations does not permit the IRS to be "intimately involved in the process of issuing tax patents." In general, applications are by statute confidential for the first eighteen months and, while most are published upon expiration of that period, the Patent Act forbids the USPTO to entertain third-party protests to published applications. Indeed, the IRS has expressed its reluctance to be involved in consideration of individual patent applications. Similarly, though such a belief might arise in other areas, no other governmental agency with regulatory authority over particular goods, services or practices is "intimately involved" in the process of examining patent applications that may relate to those goods, services or practices.

While the IRS does not have any direct involvement in the process of issuing tax patents, the IRS and the USPTO have partnered to pursue mutually beneficial training and information exchange opportunities. IRS personnel have provided training to USPTO patent examiners on financial products, wealth transfer and pensions. The USPTO has provided modified patent examiner initial training to selected IRS employees. We look forward to continuing these training and information-sharing programs.

[Questions From Ms. Tubbs Jones to Mr. Everson follow:]

Question: To your knowledge, how many of the patents that have been issued are being "marketed" by the patent holder? That is, how many of the tax strategies that have received patents do you know are being "shopped around" to taxpayers?

Answer: Based on our focused review of 14 patents and published applications we observed little conspicuous marketing of the related patents. In one case a web-site restriction (we needed to be a client) hampered our ability to drill into the site without a client password. Nevertheless, it is important to note that there is no requirement in US patent law to work (or market) the patented invention.

Question: If taxpayers are believing that a particular tax strategy has some sort of "seal of approval" because it has been patented, then should the IRS not be intimately involved in the process of issuing tax patents?

Answer: No. The process of examining and granting patents is outside the IRS' jurisdiction and expertise. Importantly, the granting of a patent on a tax strategy provides protection to the patent holder against infringement by other parties, but has no bearing on its legitimacy or illegitimacy under the tax laws, which remain under the jurisdiction of the IRS. The IRS is, however, considering taking steps to clarify for taxpayers that the tax treatment of a strategy is unrelated to any patent protection and that a patent is not an IRS "seal of approval."

Question: To what extent is the IRS currently involved?

Answer: The IRS has no involvement with the USPTO in the patent review process and does not review patents to determine whether they are valid or meet the criteria for patentability. We monitor the USPTO database to gauge the level and type of potential Tax Strategy Patents. When warranted, we review public applications and previously granted patents to learn more about the strategy in order to assess the extent of potential aggressiveness of the strategy/technique and to gain insight into areas where activity is occurring. Furthermore, in the summer of2005 we conducted a cross-Agency workshop that encompassed topics requested by the USPTO. This was an awareness workshop and was similar to what industries have historically done with the USPTO to keep them abreast of the latest sources of information, trends in practice, and the like. Our goal was to assist the USPTO in developing the resources to determine "prior art" in the area of tax strategies and structures.

Question: Of those tax patents that you have reviewed, how many do you think are abusive tax shelters?

Answer: In 2004 and 2005, we performed two searches of the USPTO data base. The first search, conducted in November 2004, was designed to identify patents and public applications of known tax shelter strategies. Specifically, we were looking for transactions the IRS has identified as "listed" transactions in Notices 2004–67 and 2005–13. These Notices describe over thirty transactions the IRS considers tax avoidance transactions. That search, which was updated in November 2005, and again in June 2006, found no evidence of patents or public patent applications embodying any abusive tax shelters or listed transactions.

Question: How many do you think are aggressive—there is a good likelihood that if audited the legality of the tax strategy will be challenged by the IRS?

Answer: It is impossible to definitively determine that a patented structure will constitute an aggressive tax strategy as used by taxpayers. This determination is inherently factual and depends on how the transaction is implemented in the real world. However, we have reviewed patents and applications to determine whether, as described in the application itself, the patented structure represents a high risk of aggressive tax planning. We conducted this type of search in July 2005, and update it periodically. The initial search just asked for patents that included the word "tax" in applications and granted patents in all classifications. We had fewer than 300 "hits". A further analysis showed that approximately 100 of these dealt with "business methods" and the majority of those appeared to be software models for computing tax impact or effect, and not tax strategies.

We pared the potential population to 14 patents and public applications primarily in the areas of employee compensation, wealth transfer, and financial products. Upon initial examination, none of the 14 patents were found to clearly involve abusive tax avoidance transactions. We have subsequently completed our review of 12 of the 14, one of which was allowed by the applicant to expire for non-payment of fees. While we do not consider them to be abusive tax avoidance transactions, we are continuing to review two of the transactions to fully satisfy ourselves that they do not present an apparent compliance risk requiring follow-up action on our part.

Question: Of those tax patents that you have reviewed, how many would you say are common tax strategies and how many are truly unique?

Answer: Considering our lack of expertise in the patent review process and the difficulty in determining "uniqueness," most (11 of the 14) of the tax strategy patents and public applications reviewed involved strategies familiar to us and thus appear to be commonly used "tried and true" techniques. Of course, it is USPTO's role to decide whether these patents meet the criteria of patentability, such as novelty and non-obviousness.

[Submissions for the record follow:]

Statement of Gavalis, Albert, New York, New York

Patenting tax-advice as a form of further-protecting otherwise privileged material

Upon "conceptually" reviewing excerpts from a pending tax-case review June 20, 2006 Wall Street Journal article by Jesse Drucker, pages C–1 and C–3, where a particular ". . . company plans to protect privileged communications with its lawyers," the article goes on to quote the company's tax-VP:

"Just as the IRS relies on the law to keep communications with its attorneys confidential, **the law also protects the confidential legal advice that citizens receive from their attorneys."**

However, the article further goes on to state that:

"The courts long have held that, in certain situations, the attorney-client privilege can't be invoked if the client shares the communications with outsiders," [such as] ". . . outside auditors . . ."

The article concludes with the juxtaposition of competing forces where while on the one hand:

"Tax lawyers have expressed concerns that **the IRS's position will prompt companies to stop sharing tax lawyers' analysis to outside accountants, leaving them with less information** when auditing public companies for the protection of investors."

On the other hand:

". . . **accounting regulators are 'not going to stand for' accountants blessing transactions without seeing all documentation."**

As such, the issue at hand would lend themselves towards the further protection of tax advice in "patented" form.

In order for companies to maintain additional protection that otherwise evaporates when attorney-client privileged material is disseminated to outside auditors, This "REQUIRED dissemination" of OTHERWISE-privileged attorney-client material to outside auditors WOULD BENEFIT FROM additional protection that "patenting" would lend itself towards providing.

Statement of Stephen T. Schreiner, Hunton & Williams

Having followed with great interest the testimony from the July 13 "Hearing on Issues Relating to the Patenting of Tax Advice," I offer the following statement which reflects my personal views as a patent attorney and not necessarily the views of my partners, my firm, or its clients:

I am a registered patent attorney with nearly 10 years experience in preparing, prosecuting, and enforcing patents. Prior to that, I worked as an electrical engineer for the Department of the Navy for nearly 9 years.

It goes without saying that the Patent Law is esoteric in general and can be particularly elusive when it comes to new technologies. We have seen these debates play out multiple times over the last 10–20 years, such as on whether man-made forms of life can be patented (early 80's), whether software can be patented (mid-90's), and whether business methods can be patented (late 90's).

In every case, we have seen that the Patent Law is a unitary, flexible system that is adapted to take on new technologies. Each of the above debates played out in similar fashions. First, there was an expression of profound surprise, even outrage by some, that certain types of new technology might be susceptible to patenting. Then there was robust debate.

But eventually these issues were resolved in favor of allowing the disputed technology to be patented so long as it satisfied the long-standing core requirements for a patent: (1) the invention has utility (is useful in some way), (2) the invention is novel (is new), and (3) the invention is not obvious (is not a trivial variation of what is already known by the public).

I submit that the issue of the patenting of tax strategies—which is really a subset of the business methods category—is resolved in exactly the same manner: the tax strategy invention at issue should be considered for a patent only if it can meet the utility, novelty, and nonobviousness requirements like any other invention.

I respectfully submit that some of the discussion, especially that leading up to the hearing, lost focus of the fundamental utility/novelty/nonobviousness standards that act as a filter in our patent system:

1. The tax strategy issue was incorrectly framed as "should somebody be able to patent a method of complying with the law?"

That is not the issue, nor the proper path of inquiry. Many different types of patentable inventions involve a manner of complying with the law, but they are not impermissible for that reason. Just a few examples of very legitimate inventions that involve compliance with the law:

a. Improved cruise control device—allows you to comply with the State speed limit.

b. Improved machine to weigh trucks before departure to ensure they are not overloaded per State law.

c. Improved airplane navigation system to ensure Federal FCC altitude limits, etc. are observed.

d. Improved baby seat that meets baby seat requirements of State law.

e. Improved seat belt system that meets seat belt requirements of State/Federal law.

g. Improved catalytic converter to more effectively meet State emissions requirements.

h. Improved car engine to meet State or Federal requirements on gas mileage minimums.

From the legal standpoint, that is, under the Patent Law, all of the above types of inventions are eligible for patents notwithstanding that they involve legal compliance.

From a policy standpoint, so long as a patent does not effectively prevent compliance with the law—i.e., it does not effectively "preempt" the law because the patent is so broad—there should be no issue.

2. The issue, like nearly all of these kinds of these discussions, turns on the long-standing standards for what can be patented: something that is useful, new, and not obvious. And, of course, the PTO must have or develop a good library of "prior art" (documenting technology already in the public domain) to make that assessment. But that is nothing new here.

Thus, a patent that is so broad that it prevents compliance with the tax law should never be granted because it cannot be new or non-obvious. In short, the existing filters in our Patent System will operate to prevent such a patent from being granted.

3. The IRS's main issue is that the emblem of a patent may give consumers the impression that the patented tax algorithm is legal and IRS-approved. Of course, as a matter of law, a patent does not provide right to use, only a right to exclude.

By way of example, one can invent a very patentable nuclear reactor technology based on cold fusion or a new drug that halts the aging process. If those inventions actually work, the inventor will receive a patent that provides him/her exclusive rights. But that does not mean that the law will permit the inventor to build the reactor in his/her back yard or start marketing those new pills.

In sum, no patent provides Governmental approval to use the invention. Thus, the issue that concerns the IRS, while it is a real issue of potential significance, is not an issue of the substantive Patent Law. Rather, it is one of building consumer awareness in a particular area where patents might be susceptible to being misrepresented by the unethical. Building consumer awareness through advertising and/or appropriate regulations by the PTO/IRS is the solution, not outlawing tax strategy patents altogether.

4. Finally, the position taken by several witnesses that tax attorneys and wealthy tax clients deserve special treatment so as not to be burdened with tax patents is unpersuasive. If doctors and patients have to observe patent restrictions on new medical techniques and new medicines that may have life-altering consequences, I cannot fathom any moral, legal, or policy basis for why tax attorneys and their clients should be enjoy a special exemption from the Patent Laws that the medical profession does not.

In closing, I thank the Subcommittee and its staff for allowing me to give my views on this topic.