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TAX SHELTERS AND THE TAX MINIMIZATION NORM: HOW DOES THE PATENTING OF TAX ADVICE TRANSFORM THE (GLOBAL) PLAYING FIELD

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ABSTRACT

The U.S. tax administration began a new era of enforcement by focusing on “cloned” tax shelters that were marketed by ambitious accounting and tax law firms to small groups of customers. That focus led to heightened transparency requirements—new disclosure rules, higher standards for tax reporting, and stiffer penalties. Even the courts, which had seemed reluctant to apply judicial doctrines to stop aggressive tax structuring, have appeared to grow new backbone in this age of stiffer enforcement expectations. Just at the time when it appears that the attention to tax shelter activity may reduce the amount of aggressive planning, the U.S. Patent and Trademark Office has thrown a wrench into the machinery by issuing a series of patents on tax planning strategies, after the State Street decision opened the way for business method patents.

The patenting of tax strategies may have significant effects well beyond the questions of royalties, liabilities for infringement, or difficulties of litigating against validity of a tax patent that are already the subject of discussion among tax practitioners and academics. There are concerns, in particular, that the ability to patent legal processes relating to tax liabilities may make it more difficult for taxpayers to comply with the law. This essay will briefly review the concerns raised by tax strategy patents, including ethical questions confronting practitioners who hold a tax strategy patent, the potential impact of tax

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patents on the development of the underlying “tax minimization norm” that this author has noted in earlier papers as a significant factor in tax shelter activity, and the anti-competitive effects of multijurisdictional tax strategy patents

I. INTRODUCTION

After World War II, the United Nations promoted world peace through the removal of trade barriers. This process of trade liberalization has progressed rapidly, leading to today’s globally integrated economy, with financial, communications, and manufacturing activities operating across national boundaries. E-commerce brings businesses and their customers together across the globe; marketplaces are increasingly international, not national or local. Yesterday’s competitor becomes tomorrow’s joint venturer, each governed by the various regulatory and tax jurisdictions that may apply to a single commercial transaction.

Globalization of markets has clearly brought with it an accelerating trend towards globalization of the legal rules underlying those markets. Even in areas that have traditionally been considered strongly territorial in nature and left to the jurisdiction of the different nations, such as bankruptcy, there has been considerable discussion, at the least, of the value of universalism in rules and consistency across borders in order to facilitate the smooth functioning of the global marketplace and avoid conflicting treatments of multinational players.¹

The trend towards harmonization seems particularly evident in areas that have traditionally demanded at least a minimal level of transnational cooperation, such as tax. Globalization has accelerated the development of bilateral tax conventions to avoid double or no taxation because of extraterritorial activities and the adoption by emerging economies of sophisticated tax concepts that are relatively common in developed countries, such as rules governing conduit

1. See, e.g., Robert Rasmussen, *Where Are All the Transnational Bankruptcies? The Puzzling Case for Universalism* (Vand. Law Sch. Law & Econ. Working Paper No. 7-13, 2007), available at <http://ssrn.com/abstract=982678> (stating that “[u]niversalism is on the march” and that after a century of a “quixotic quest”, “[t]he tide has seemingly turned”).

financing arrangements and controlled foreign corporation regimes similar to the U.S. scheme for taxing currently certain profits earned overseas. Some evidence points to convergence in rate structures and types of taxes, though the array of possible taxing systems and territorial differences makes true convergence or universalism in tax law highly unlikely.

Accompanying the development of these globalized markets is a rapidly developing international interest in the intellectual property rights that underlie the global economy. In fact, in many ways one might argue that the future of globalization lies in the resolution of issues related to these intangible property rights. They raise a number of difficult issues, from determination of which nation has (or should have) jurisdiction to tax the profits from exercising these intangible rights to the proper scope of a right granted by one nation. On the one hand, market globalization creates significant pressure for harmonization of intellectual property rights—a trademark that is meaningful in one country is worth much less than one that can be enforced consistently across national boundaries. Accordingly, the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS),² as interpreted by the European Court of Justice (ECJ) and the World Trade Organization’s Appellate Body, moves towards harmonized trademark protection across national jurisdictions.³

On the other hand, a competitive war has developed in the United States in which the “most visible battlefield” is the courtroom, where companies engage in patent litigation over the rights to

2. See Marrakesh Agreement Establishing the World Trade Organization, Apr. 15 1994, Annex 1C, 33 I.L.M. 1197 (1994), available at http://www.wto.org/english/tratop_e/trips_e/t_agm0_e.htm. The United States committed to minimal standards of patent protection in the TRIPS Agreement in connection with establishment of the World Trade Organization.

3. See, e.g., Gail E. Evans, *Substantive Trademark Law Harmonization by Means of the WTO Appellate Body and the European Court of Justice: The Case of Trade Name Protection*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=965891 (noting the “advent of a global epoch in trademark rights” with an increasing need for trademark law harmonization and suggesting that the disputes settlement understanding provides “an opportunity to penetrate and if necessary to amend national trademark laws that are found inconsistent”).

ownership of particular business methods, patentable under U.S. patent laws after the *State Street Bank* decision, that may determine who controls key technologies and processes in the global economy.⁴ Financial institutions—key players in the development of the global economy—have become eager participants in the burgeoning business method patent process, developing brokerage, investment banking and asset management patents covering software applications to business methodologies.⁵ This has led to an “increasingly impenetrable ‘patent thicket’ of complicated, vague and overlapping claims.”⁶

Patents provide two distinct benefits—royalties from licensing the patent and exclusion rights. With business method patents, both these benefits of patents create opportunities for market-distorting transaction costs. The fee or royalty rewards an inventor who licenses a company to use the new process in a commercial enterprise. There are also rising numbers of “patent trolls,” companies that purchase patents from the holder in order to demand revenues or infringement awards from large companies when they inadvertently infringe on the patent, rather than to facilitate the commercialization of the new

4. Joel E. Lutzker & Anna Vishev, *Patents on Wall Street*, IP Worldwide, December 13, 2002, at 20, available at <http://www.law.com/jsp/article.jsp?id=1039054440840> (discussing the impact, in just a few short years, of *State Street Bank & Trust v. Signature Financial Group*, 149 F.3d 1368 (Fed. Cir. 1998), which permitted patenting of business methods).

5. See, e.g., Barry Grossman, *Patents Now Play Important Role in Financial Industry*, 169 Am. Banker 10 (Dec. 17, 2004), available at http://www.foley.com/files/tbl_s31Publications/FileUpload137/2436/3854ab.pdf. (indicating increase of financial services patents from 330 in 1995 to 8,700 in 2001); Mark A. Lemley and Carl Shapiro, *Reply: Patent Holdups and Royalty Stacking* (John M. Olin Program in Law & Econ., Stan. Law Sch. Working Paper No. 345, August, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1005727.

6. Peter Haapaniemi, *Have We Lost Our Way?*, Ip Bus., Spring/Summer 2006, at 4 available at http://www.wilmerhale.com/files/Publication/660695f1-b168-4618-a7aa-062f492d643b/Presentation/PublicationAttachment/6ce9b7cc-020c-402f-a734-11f234a8fdcd/IPBiz_2006_SpringSummer.pdf.

patented idea.⁷ Business method patents also are highly effective anti-competition measures, in that they permit the holder to exclude others from using the patented methodology to execute a similar business, a much broader scope for monopoly protection than generally envisioned when one considers patents on particular types of machines. They effectively secure protection for the life of the patent against level-playing-field competition with the patent holder by providing a monopoly on a particular method of doing business,⁸ changing the role of patents from “fuel for the engine to sand in the gears.”⁹

The possibility of patenting business methods raises concerns beyond the economic. For example, the patenting of medical processes raised ethical concerns about the physician-patient relationship, the autonomy of physicians, and the potentially deleterious effect on development of new medical knowledge as researchers “hog” their work to develop lucrative patents rather than share their work with others through objective reporting in scientific journals.¹⁰ Those concerns were countered to the extent that the availability of medical process patents incentivized physicians, hospitals, and other organizations to conduct costly clinical research. Ultimately, Congress enacted an exception for surgical method patents that immunizes direct infringers.¹¹

7. Haapaniemi, *supra* note 6 at 6. (reporting Berkeley professor Carl Shapiro’s concern that often these patent trolls have nothing to lose, resulting in “asymmetric warfare” in pursuit of infringement claims).

8. *See* Haapaniemi, *supra* note 6, at 7 (discussing Amazon.com’s suit against barnesandnoble.com enforcing its patent on the “one-click method” for internet sales). *See also* Edmund Kitch, *Patents: Monopolies or Property Rights?*, 8 Res. L. Econ. 31 (1986) (noting that patents confer monopoly power only to the extent that there are no close substitutes for the patented item).

9. Haapaniemi, *supra* note 6, at 7. (quoting Brandeis economist Adam Jaffe).

10. *See, e.g.*, Gregory F. Burch, *Ethical Considerations in the Patenting of Medical Processes*, 65 Tex. L. Rev. 1139 (1987) (discussing ethical concerns and legislative remedies relating to medical process patents).

11. Physicians Immunity Statute, 35 U.S.C. § 287(c) (1996). The amendment generally denies damages or injunctive relief against licensed medical practitioners or related health care facilities in connection with the performance of a medical

The most recent development in the area of business method patents is the possibility of patenting tax planning strategies. The United States Patent and Trademark Office (USPTO) has already issued a number of these patents and there are applications for many more in line for patent review.¹² Issuance of a patent does not certify the strategy as legitimately carrying the intended tax consequences under federal tax law, which is a determination made by the Internal Revenue Service (the IRS) and the courts rather than the USPTO.¹³ There are a number of other economic, ethical and practical concerns with tax patents. Various commentators have considered the impact of tax planning patents on tax planning professionals and firms and the social consequences of such patents.¹⁴ The American Bar Association Tax Section, for example, has devoted considerable time over the last two years to questions related to tax strategy patents, including the establishment of a task force to explore the patenting of tax-related advice.¹⁵ Various state bar associations, accountancy groups and

activity that constitutes an infringement of a patent, but not covering patented machines or biotechnology.

12. The U.S. Patent and Trademark Office website maintains a list of patents that are classified as data processing (Class 705) tax strategies (36T) at http://www.uspto.gov/patft/class705_sub36t.html.

13. In theory, one should not be able to patent an unlawful transaction. However, the USPTO generally presents its work as focusing on the specific patent law requirements and not on questions of the legal validity of the activity sought to be patented.

14. See, e.g., Dan Burk & Brett McDonnell, *Patents, Tax Shelters, and the Firm*, (University of Minn. Law Sch. Legal Stud. Res. Paper Series Res. Paper No. 07-05, 2006), available at <http://ssrn.com/abstract=961749> (suggesting that tax planning firms may benefit but the overall social consequences of such patents are “potentially negative on net”).

15. See, e.g., Stephen Joyce, *Number of Tax Strategy Patents Increasing, Could Affect Practice of Law, Speakers Say*, Daily Tax Rep. (BNA), Oct. 24, 2006, at G-9 (commenting on the ABA’s October 20 plenary session on tax patents and the establishment of a task force on tax strategy patents); Dustin A. Stamper, *ABA Suggests Making Patented Tax Strategies Reportable Transactions*, 2007 TNT 36-1, Feb. 22, 2007, available in LEXIS, TNT File.

others have weighed in on the controversy.¹⁶ As tax patents have become more visible, Congress has recognized their importance, holding a series of hearings on issues related to patenting of tax strategies. The House has now passed legislation banning tax patents as part of a larger patent reform bill, but the Senate has yet to act.¹⁷ Although foreign patent offices have not yet succumbed to the inevitability of business method patents, the push for consistency has

16. See, e.g., Letter from Todd Welty, State Bar of Texas, to Eric Solomon, Treasury Department (Jan. 29, 2007) (recommending that patented strategies be identified as transactions of interest and patent applicants and holders be treated as material advisors under the reportable transaction rules); Letter from the Virginia Society of CPAs to AICIPA Chair Leslie Murphy (Oct. 6, 2006) (stating that patenting tax advice does not represent good public policy); Alison Bennett, *Colorado Bar Group Opposes Tax Patenting, Voices Big Support for Legislative Remedy*, Daily Tax Rep. (BNA), Mar. 15, 2007, at G-1; Letter from Tax Section of the Florida Bar on Patentability of Tax Advice and Senate Bill 681 to Senator Norm Coleman, Senator Carl Levin & Senator Barack Obama (Apr. 23, 2007), at http://www.floridatallaxlawyers.org/pdf/patentability_taxadvice_bill681.pdf; Brett Ferguson, *Efforts to Ban Tax Patents at Risk of Being Watered-Down in Congress, Attorney Says*, Daily Tax Rep. (BNA), Oct. 12, 2007, at G-8; John A. Squires, *Solution for Tax Patent Distemper Should be Transparency*, Daily Tax Rep. (BNA), Oct. 12, 2007, at J-1.

17. See Alison Bennett, *House Judiciary Panel Explains Stance On Tax Strategy Patent Ban in New Report*, Daily Tax Rep. (BNA), Sept. 6, 2007, at G-1.; *Hearing on Issues Relating to the Patenting of Tax Advice* Before the Subcomm. On Select Revenue Measures of the H. Comm. on Ways & Means, 109th Cong., 2d Sess. (2006); Patent Reform Act of 2007, H.R. 1908, 110th Cong. (2007), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h1908eh.txt.pdf. This bill bans patents of tax strategies. Although it is on the Senate legislative calendar, no action has taken place and there is no certainty regarding potential Senate action. See Brett Ferguson, *Efforts to Ban Tax Patents at Risk of Being Watered-Down in Congress, Attorney Says*, Daily Tax Rep. (BNA), Oct. 12, 2007, at G-8. Senators are also presenting their own plans to ban tax patents. See Alison Bennett & Carol Oberdorfer, *Levin, Coleman, Obama Introduce Measure to Curb Foreign Abuses, Stop Tax Patents*, Daily Tax Rep. (BNA), Feb. 21, 2007, at G-2 (reporting the introduction of the Stop Tax Haven Abuse Act by Senators Carl Levin, Barack Obama and Ron Coleman on February 17, 2007, a stand-alone bill banning tax patents that differs from the Patent Reform Act in the House). See also Alison Bennett, *Baucus, Grassley, Others Crafting Legislation Solely to Ban Tax Strategy Patents, Aides Say*, Daily Tax Rep. (BNA), Sept. 13, 2007, at GG-1.

resulted in their “fighting a losing rearguard action to resist such patents.”¹⁸

This essay considers this new U.S. phenomenon of patents on tax planning strategies and in particular its possible implications for the development of the integrated, globalized economy. As a tax lawyer, I do not profess significant expertise in the area of patent law. I believe that it is important, however, to consider the potential impact on global markets and competition if patenting of such tax planning strategies survives in the United States and is mimicked in other jurisdictions as part of the drive towards harmonization of intellectual property rules. As one group of commentators has noted,

[T]he grant of any patent is a troubling practice: patents and other forms of intellectual property artificially raise prices, restrain trade, and hamper access to what would otherwise be a publicly available good. These costs of exclusivity are typically justified as being outweighed by the benefit of intellectual property as an incentive to investment.¹⁹

The issue here is whether the “troubling practice,” in the international context, imposes such distortive transaction costs and burdens on the global marketplace that countries should take that cost into consideration in deciding whether to permit patenting of tax strategies or instead specifically to exclude tax planning methods from the scope of patentable subject matter.

This essay proceeds as follows. Part II provides a brief overview of the current U.S. patent system. Part III addresses the most significant concerns in connection with the recent issuance of tax strategy patents. Part IV considers briefly the international patent law context and the current status of business methods patents in the U.S.’s major trading partners, such as Europe and Japan. Part V then considers the possibility that the U.S. position on patentability of tax strategies may eventually be accepted abroad and ponders the implications of that for a globalized economy. The essay concludes

18. Burk & McDonnell, *supra* note 14, at 3.

19. Burk & McDonnell, *supra* note 14, at 3.

with a tentative recommendation for international interpretation of patent law requirements.

II. THE U.S. PATENT SYSTEM

The primary benefit of a patent is the acceleration of inventions that are socially useful, by means of a financial incentive to the inventor that permits the inventor a means of recouping high research and development costs. The incentive provided is a monopoly for a relatively short period of time—20 years from filing.²⁰ The monopoly cost of granting patents has been considered acceptable for two principal reasons: the public can use the invention even during the period of the monopoly for the price of the licensing fee, and the invention becomes freely available to the public after the monopoly period ends.²¹ The publication of the issued patent is considered to stimulate innovation built on the patent's new ideas even during the monopoly period: “[o]thers can build upon the disclosure of a patent instrument to produce their own technologies that fall outside the exclusive rights associated with the patent.”²² Furthermore, patents are considered to facilitate market transactions, since they “decrease the ability of contracting parties to engage in opportunistic behavior.”²³ Patents are therefore seen generally as of greater public benefit than

20. If a patent issues, the patent holder obtains the right to exclude others from making, using, selling or offering to sell or importing the patented invention. 35 U.S.C. § 271(a). The maximum term is ordinarily 20 years from the date the patent was filed. 35 U.S.C. § 154(a)(2). Those who use a patented technology without the patentee's permission during the term of the patent may be sued for infringement.

21. See, e.g., Yoram Barzel, *Optimal Timing of Innovations*, 50 *The Rev. of Econ. and Statistics* 348 (1968); J.C. Dammann & Henry Hansmann, *A Global Market for Judicial Services* (U. of Texas Law, Law and Econ Res. Paper No. 98,) (2007), available at <http://ssrn.com/abstract=976115>.

22. Wendy H. Schacht & John R. Thomas, *Patent Reform: Innovation Issues*, Congressional Research Service, Report for Congress, Order No. RL32996 (July 15, 2005), available at http://tlc.usm.maine.edu/cli/documents/crs_report_patent_reform.pdf (last visited Feb. 28, 2007).

23 *Id.* at 4.

trade secrets, which do not result in public disclosure of useful information.

Although patents are disclosed when issued, patent applications remain secret for the first eighteen months after filing.²⁴ They are disclosed after that initial period, unless the applicant has certified that there is no plan to seek foreign patent rights.

The patent process in the United States is “a largely insular system shield[ed] from outside influence, with patents being granted based on examinations by a single patent examiner with a limited sphere of knowledge.”²⁵ The basic requirements for patentability are a suitable “process, machine, manufacture or composition of matter, or any new and useful improvement thereof” that is useful, novel, and nonobvious.²⁶

The “process, machine, manufacture or composition of matter” language defines patentable subject matter very broadly. In addition, the U.S. Patent Act defines a patentable process circularly as a “process, art or method.”²⁷ Although abstract ideas or laws of nature per se have never been considered patentable,²⁸ the USPTO has applied broadly the 1998 *State Street Bank* decision, in which the court

24. 35 U.S.C. § 122(b) (2000).

25. Matthew John Duane, *Lending a Hand: The Need for Public Participation in Patent Examination and Beyond*, at 1 (2007), available at <http://ssrn.com/abstract=970832>.

26. 35 U.S.C. §§ 101-103. Novelty is determined by whether the invention has appeared in printed publications, has been available for public use or subject to sales, patent or other patent applications. 35 U.S.C. § 102(a)-(e). Nonobviousness does not exist if the “differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art. 35 U.S.C. § 103(a); *See also In re Comiskey*, 499 F.3d 1365 (Fed. Cir. 2007) (remanding case in part to determine whether a business method patent for mandatory arbitration that would fail as a mental process could satisfy the nonobviousness standard with the addition of computers or modern communication devices).

27. 35 U.S.C. § 100(b).

28. *Diamond v. Chakrabarty*, 447 U.S. 303, 309 (1980) (“laws of nature, physical phenomena, and abstract ideas have been held not patentable”). *See also Parker v. Flook*, 437 U.S. 584 (1978).

broke with prior understanding by holding that business methods could be patentable as practical applications that produce “a useful, concrete and tangible result.”²⁹ Consequently, virtually any application of rules that can be described in a series of steps resulting in some combination of data or change of qualification can be patentable, including calculations that are little more than mathematical algorithms. The USPTO considers not only business methods but also legal processes—applications of laws, including the federal income tax laws—as a type of patentable process.

Contrary to what one might expect, the utility requirement does not require the USPTO to consider whether the process itself actually produces a *public* benefit: the invention merely must function so that some party is helped to achieve the result claimed for the process.³⁰ In the face of sharp criticism of its decision to patent applications of tax laws, the USPTO has, however, taken the position that patenting tax strategies is advantageous because it facilitates public disclosure of new methods rather than treating them as trade secrets maintained confidentially.³¹

The core requirements for a valid patent, and the ones that are the most important for tax patents, are novelty and nonobviousness. Novelty requires that the invention not be fully anticipated by a prior patent or a publication or other knowledge that is within the public domain.³² Nonobviousness requires that the invention not have been readily comprehended within the ordinary skills of a competent artisan in the field at the time the invention was made.³³ The Federal Circuit,

29. *State Street Bank & Trust Co. v. Signature Financial Group, Inc.*, 149 F.3d 1368, 1373 (Fed. Cir. 1998).

30. *See Juicy Whip, Inc. V. Orange Bang, Inc.*, 185 F.3d 1364 (Fed. Cir. 1999) (explaining USPTO need not reject a patent that has no public benefit; it is up to congress to make those public policy decisions).

31. Wesley Everson Elmore, *Tax Writers Scrutinize Patenting of Tax Strategies*, 2006 TNT 135-3, July 14, 2006, available in LEXIS, TNT File (citing USPTO executive Toupin).

32. 35 U.S.C. § 102 (2002).

33. 35 U.S.C. § 103 (2004).

the federal court with exclusive appellate jurisdiction over patent cases, has developed a fairly lax standard for testing obviousness, resulting in a pro-applicant trend in grants of patents and a concern that the quality of the granted patents has deteriorated.³⁴

Although the patent examination process typically requires only one patent examiner to review the application and search available databases for prior art, the patent process does permit some input from third parties. Third party participation, however, is very costly, both in upfront fees for *ex parte* or *intra partes* examinations (from about \$2500 to more than \$8000, respectively) and in potential loss of valuable prior art references due to estoppel in later litigation.³⁵ In practice, third party participation is very limited in use. As a result, there is considerable commentary from academics and practitioners regarding the decline in quality of patents issued, due to the patent office's inability to conduct the in-depth review of materials with the time and resources allotted. The issuance of more patents that will not (or should not) stand the test of enforcement litigation distorts the markets: infringers either bear extraordinary costs for litigating the validity of the patent or pay the royalty to avoid the lawsuit, even though they know the patent should not be considered valid.³⁶ Even if

34. The Supreme Court has passed up several opportunities to hear patent cases, but its decision in a recent case may have pushed back against the Federal Circuit's obviousness standard. That case is *KSR v. Teleflex, Inc.*, 127 U.S. 1727 (2007), available at <http://www.supremecourt.us/opinions/06pdf/04-1350.pdf>. The KSR Court held that the Federal Circuit had applied a rigid and formulaic test that kept it from recognizing ordinary inventiveness that should not be worthy of a patent. For a discussion of the potential impact of the decision on issuance of business process patents (and hence, on tax strategy patents), see also James W. Dabney & John F. Duffy, *Supreme Court Decision Could Thwart Business Process Patents*, Executive Counsel, Nov./Dec. 2006, at 19, available at http://www.ffhsj.com/reprints/061120_exec_counsel_dabney.pdf.

35. See, e.g., Duane, *supra* note 25 (describing the points of possible intervention in the patent process to show lack of novelty or nonobviousness in some detail).

36. "Poor patent quality may also encourage opportunistic behavior. Perhaps attracted by large damages awards and a potentially porous USPTO, rent-seeking entrepreneurs may be attracted to form speculative patent acquisition and enforcement ventures. Industry participants may also be forced to expend considerable sums on patent acquisition and enforcement. The net results would be

a patent is proven invalid, the patent holder may have already garnered such a lead that its customers are “locked in” to the patent holder’s network of services.³⁷ These bad patents increase the rate of patent litigation and influence the rise of “patent trolls” —a “derisive term levied against parties who obtain patents for certain technologies but, instead of producing end products from them, instead use them to obtain licensing agreements and court settlements from other companies in that arena.”³⁸

Litigating patents costs at least in the hundreds of thousands of dollars.³⁹ A 2000 report by the Congressional Research Service notes that average costs of patent enforcement may be as high as \$1.2 million, higher stakes litigation may cost as much as \$4 million to each party, and companies like Microsoft, with 35-40 cases a year, may spend more than \$100 million annually on patent litigation.⁴⁰

It is not just competitors of patent holders who are affected. Patent owners who do intend to use their patents to engage in productive activities may make inappropriate decisions based on expectations of exclusive rights. If their patent turns out to be invalid after an enforcement proceeding, they will suffer a loss on their investment, with no compensation. If this were to happen to a significant number of patent holders, it would likely result in decreased investments in innovative technologies.⁴¹

reduced rates of innovation, decreased patent-based transactions, and higher prices for goods and services.” Schacht & Thomas, *supra* note 22, at 6.

37. Stan Liebowitz, *Network Effects, Path Dependence, Lock-In, and Digital Copyright Issues*, <http://www.utdallas.edu/~liebowitz/> (last visited February 29, 2008). Liebowitz, who is a professor of economics at the University of Texas, has been critical of lock-in and network effects theories.

38. Duane, *supra* note 25.

39. William A. Drennan, *The Patented Loophole: How Should Congress Respond to this Judicial Invention?*, 59 Fla. L. Rev. 229, 293 (2007) (stating that typical patent enforcement litigation costs \$250,000 to \$750,000).

40. Schacht & Thomas, *supra* note 22, at 7.

41. See Schacht & Thomas, *supra* note 22, at 7.

III. CONCERNS ABOUT TAX STRATEGY PATENTS

There are a number of concerns about the application of the patent system to tax law. Some of the general concerns about patents are inapplicable to tax strategy patents: for example, the patent holder who uses a patented tax strategy does not lose out on the investment if the patent turns out to be invalid—the holder pays taxes owed on his transactions, whether or not he has a patent governing the structure used. Many of the general patent law concerns do apply, however, in considering tax patents, especially those related to the inadequacy of the patent office to the task of dealing with new domains. A number of the concerns are unique to the tax law area. This section will explore those concerns that seem most pressing for tax practitioners and tax administrators.

Extending patent protection for either routine compliance with tax laws or development of aggressive tax shelter transactions is directly counter to sound tax policy and to the policies for encouraging publicly beneficial innovation that underlie the patent system. First, the explicit goal of patent law—to encourage innovation—runs counter to public policy in the tax area. Tax innovations are simply not subject to the public goods problem that prevents the creator from charging enough for use of the strategy to recoup the research costs.⁴² Tax practitioners who advise clients on transactional activities already have every incentive to devise new strategies for their clients, since that is the primary way in which they bring in new clientele. They receive both monetary rewards (client payments) and status rewards (reputations as brilliant tax planners) by devising workable tax strategies.

Furthermore, in the case of aggressive tax planning strategies that might be considered abusive, the patent goal of providing economic returns to innovation through the grant of a monopoly is simply inapplicable. There is no need to encourage tax practitioners to innovate. In fact, incentivizing invention of new tax loophole

42. See David Olson, *Patentable Subject Matter: The Problem of the Absent Gatekeeper* (Sept. 27, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=933167.

strategies runs counter to a strong public policy of discouraging the existing rampant innovation in this area.

To respond to a spate of aggressive and perhaps illegal tax shelter activity, Congress and the Treasury Department have developed the reportable transaction regime, aimed at making tax planning more transparent and reducing the economic incentives for tax attorneys and other tax practitioners to develop tax loopholes.⁴³ The reportable transaction regime and Circular 230 regulations for practice before the Internal Revenue Service have combined new disclosure rules, heightened standards for tax reporting and stiffer penalties to make treatment of tax loopholes as “trade secrets” (which are maintained through confidentiality agreements) too expensive to be viable. The new regulations have eliminated the windfall possibility of contingent fees for regular tax planning advice and pressured tax practitioners to conduct a more thorough analysis of the tax law requirements. Patents for tax strategies undermine this policy objective by providing a way to maneuver around the reportable transaction regulations.⁴⁴ Because aggressive tax planning strategies result in lower revenues for the public fisc and/or higher taxes for those not able to benefit from such strategies (resulting in inequities within the tax system), providing patents to these aggressive planning strategies undermines tax policy and does not promote socially beneficial innovations, the underlying goal of the patent system.

In fact, patents for tax strategy may not only fail to serve a positive public policy (encouraging innovation) but could actually foster a damaging type of innovation. Tax laws change frequently, and tax practitioners already pay particular attention to areas of change that may be mined for new tax minimization strategies. In effect, tax practitioners hope to arbitrage the technical wording of the provision against the underlying purpose that Congress intended the provision to accomplish. If they succeed, they will have a new shelter until

43. Treas. Reg. § 1.6011-4(a) (2007) and related regulations.

44. See Diane Freda, *Attorneys Advised Tax Strategy Patents Nothing New*, Daily Tax Rep (BNA), Nov. 2, 2006, at G-12 (noting statement by Georgetown professor Jay Thomas that tax attorneys say they use patents “so they don’t have to make it confidential”). *But see infra* note 47 and accompanying text discussing proposed regulations requiring reporting of patented transactions.

Congress or the Service acts to end it. Patents will exacerbate this process by encouraging a race to file among tax practitioners dedicated to examining new statutes, regulations, and case decisions for exploitable loopholes in an effort to capture the rents to be gained from each new change to the tax laws.

Large law firms, accounting firms and even investment banks may have a distinct advantage in this process because of the numbers of available associates who can be assigned to the creative task of inventing ways to use the new provisions. It is quite possible that certain large players will dominate the tax patent process and hold a broad portfolio of patents, especially in particular areas, such as estate and gift tax and financial transactions. The possibility of building massive patent portfolios may also provide for tax patent trolls, willing to buy up patents to exact fees from those who need to use the patented process. These trolls would capitalize on the asymmetry of their positions: They are not competitors subject to potential counterclaims, but can legitimately threaten to halt use of a needed strategy.⁴⁵ Both consolidation and trolls would make it hard for small firms or startups to find a niche, due to the extra transaction costs for licensing tax strategies held by the big firms.

Second, the secrecy permitted for eighteen months of the patent application process may assist tax practitioners in fending off Service scrutiny of the patented strategy. Many U.S. patents on tax strategies will undoubtedly be for domestic applications. Under current law, such patent applications will likely remain undisclosed until the patent is issued.⁴⁶ Such secrecy may provide a way for tax planners to avoid some of the transparency requirements developed to counter the tax shelter business, though current developments suggest the Service is aggressively monitoring that possibility. Prior to the reportable transaction rules, many tax shelters were subject to

45. Schacht & Thomas, *supra* note 22, at 9, 34.

46. Tax strategies are generally not patentable in other countries, so it is currently highly unlikely that a patent applicant would seek to patent the strategy abroad. As cross-border transactions increase, however, pressure will grow to permit patenting of tax strategies in both transaction jurisdictions, if U.S. tax strategy patents continue to be permitted. *See* Young, *infra* note 76 and accompanying text.

confidentiality agreements that prevented various participants in the transaction from disclosing the nature of the deal. Such confidentiality agreements permitted tax shelter practitioners to avoid tax scrutiny on the deal by taking advantage of both the low numbers of audits and the difficulty of detection of issues on audits (the so-called “audit lottery”). The deal could be sold to a relatively small number of taxpayers without drawing government attention. The reportable transaction rules were developed in part to mandate disclosure for transactions covered by confidentiality agreements. Without mandated transparency, transactions covered by patent applications would have a grace period during which time the transaction remained secret but not subject to the reportable transaction rules. The Service, however, has recently issued proposed regulations that designate a new category of reportable transactions for patented transactions.⁴⁷

Even if tax patents are not used for aggressive transactions and the Service receives notice after it finalizes the new reportable transaction regulations, the eighteen-month interval between filing an application and public disclosure could be problematic for advisers and taxpayers. The timing of tax advice and the patent process could well result in tax advisers initiating a transaction structure with a client while the patent application is pending and secret, causing the client to infringe on the patent when it issues, unless the prior use exception is available.⁴⁸

Third, the advent of business and legal method patents, and in particular of tax method patents, is especially worrisome because of

47. Prop. Treas. Reg. § 1.6011-4, 72 Fed. Reg. 54615-54618 (Sept. 26, 2007) (adding a “patented transactions category” and applying to taxpayers under § 6011, material advisors responsible for disclosing under § 6111 and material advisors required to maintain lists under § 6112). Under the regulations, a patented transaction includes any one for which a taxpayer pays a fee to a patent holder or the holder’s agent for the right to use a tax planning method subject to a patent or any one in which a taxpayer who is the patent holder or patent holder’s agent has a right to payment for another’s use of a patented tax planning method. *See also* Alison Bennett, *Definitional Issues Loom in Circular 230, Tax Patent Areas, Treasury Officials Say*, Daily Tax Rep. (BNA), Oct. 23, 2007, at G-7.

48. William C. Weinsheimer & Barry L. Grossman, *Intellectual Property Rights in Estate Tax Strategies*, ABA Section of Taxation 2007 Midyear Meeting, Estate and Gift Tax Committee (Jan. 19, 2007).

the lack of expertise of the USPTO staff in federal income tax law. As everyone knows, tax law is extraordinarily complex. Tax practitioners require years of practice before they can be considered experts, and even then, they generally work primarily in limited domains of the tax law, such as in partnership, corporate, or financial product taxation. The Service has considerable difficulty finding experts who will remain in government and are capable of reverse-engineering the various financial transactions and tax strategies used by sophisticated taxpayers to minimize their taxes. The USPTO engineers and patent examiners are aware of their own lack of tax expertise in the tax law, but they have neither the funding nor the focus to develop the depth of expertise that would be required to become sufficiently competent in recognizing prior art in tax planning.⁴⁹ The USPTO has a shortage of examiners, a constantly increasing number of applications, a growing backlog, limited search tools, sparse disclosures by applicants, and a limited amount of time for processing (roughly eighteen hours per application).⁵⁰

Fourth, the potential for issuance of tax strategy patents for methods that have been common knowledge within the tax community is very high. Even with additional input and training from the Service and interested practitioners through the American Bar Association, the USPTO remains unprepared to assess the subtleties of sophisticated tax planning strategies. Furthermore, many of the discussions of tax strategies take place within practitioner organizations or academic gatherings and may not lead to publication in a database that the USPTO relies on for searches for prior art.⁵¹ The fact that most tax minimization planning is done on a one-on-one basis between a tax adviser and a client, subject to the attorney-client privilege, further complicates the issue. Thus, the attorney is under an obligation to

49 Joint Comm. on Taxation, Background & Issues Relating to the patenting of Tax Advice, JCX-31-06 (July 13, 2006), available at <http://www.house.gov/jct/x-31-06.pdf>.

50. Duane, *supra* note 25, at n. 63.

51. See Michael Brier, *Patently Foolish?*, Fin. Adviser, Oct. 2007, available at http://www.fa-mag.com/past_issues.php?id_content=3&idArticle=1333&idPastIssue=114 (last visited Feb. 28, 2007).

refrain from discussing his client's transactions and their tax consequences and cannot divulge those facts to establish prior art and prevent another from benefiting from a patent. Either the attorney must secure permission from a client to reveal information about the client's use of the strategy, or the practitioner must argue in abstract terms that do not satisfy the USPTO's requirements for conclusive evidence about prior use. This is particularly problematic, since the remedies for patent infringement suits, which are already costly to defend, can be substantial (including treble damages for willful infringement).⁵² This will likely continue to present a critical problem for tax strategy patents.

To illustrate the mismatch of skills and required analysis in this area, an example that has garnered significant media and practitioner attention is the SOGRAT patent. The USPTO issued a patent for a common kind of trust, a grantor retained-annuity trust or "GRAT", that is funded by stock options: the SOGRAT patent.⁵³ Various taxpayers, including at least fourteen large law firms, have paid license fees to the holder of the patent to use the SOGRAT. Yet, most experienced tax practitioners do not consider the combination of these two common tax ideas as novel. One academic commentator, William Drennan, provides an extensive discussion of the many ways in which the SOGRAT would be considered an obvious option to most estate and gift tax practitioners:

[I]f stock options represent a significant portion of a client's wealth and the estate will be liable for estate taxes at death, one could argue that a person having ordinary skill in the art of estate planning would review the standard group of estate planning devices that can reduce a taxable estate, include the GRAT. Prior to the filing of the patent application for the SOGRAT, the prior art stated that assets that can significantly

52. 35 U.S.C. § 284 (2000).

53. See U.S. Patent No. 6,567,790 (filed Dec. 1, 1999) (issued May 20, 2003). The patent is the subject of *Wealth Transfer Group LLC v. Rowe*, No. 3:06-cv-00024 (D. Conn. filed Jan. 6, 2006). See also Stephen Joyce, *Federal Case Highlights Debate Over Patenting of Tax Strategies*, Daily Tax Rep. (BNA), July 18, 2006, at G-5.

appreciate in value, including stock, are excellent candidates for contribution to a GRAT. Accordingly, one could argue that there was a ‘teaching, suggestion or incentive’ to contribute stock options to a GRAT.⁵⁴

Moreover, the issuance of patents for tax strategies will tend to stifle the communications among tax practitioners (both lawyers and accountants), in contrast to the current culture, which provides for vigorous debate among experts about the pros and cons of particular tax strategies.⁵⁵ Such discussions permit practitioners to develop a better sense of what may be permissible under the Internal Revenue Code. The loss of a productive interchange would be deleterious for tax practitioners, who will lose one of the means of gaining expertise through communications with more experienced lawyers in the field, and for taxpayers, whose advisers will not have the benefit of the collegial analyses of tax strategies. The Service will also lose out, since the discussions provide an excellent opportunity for tax experts to comment on Service positions and, in many cases, provide examples of practical limitations or applications of which the Service might not be aware.

In addition to economic and procedural concerns, tax strategy patents raise a number of ethical issues for tax practitioners. A lawyer who files patent applications on tax strategies will need to consider whether the strategy belongs to the client for whom it was developed and whether the practitioner has an ethical duty to suggest that the client patent the strategy or, at least, to disclose the lawyer’s intent to file. The lawyer will have to consider the patent in determining the reasonableness of fees for the work done for the client.⁵⁶ If the lawyer has developed the strategy outside of a client context, the lawyer may have violated conflict of interest rules in proposing the patented strategy or in charging unreasonable fees for its use.⁵⁷ In particular, tax

54. William A. Drennan, *The Patented Loophole: How Should Congress Respond to this Judicial Invention?*, 59 Fla. L. Rev. 229, 266 (2007).

55. See Weinsheimer & Grossman, *supra* note 48.

56. See Model Rules of Prof’l Conduct R. 1.5.

57. See Model Rules of Prof’l Conduct R. 1.7.

lawyers who hold tax strategy patents and provide a license to other attorneys will have to carefully consider whether the licensing agreement constitutes a “promoter” tax opinion subject to the special reportable transaction rules and the stringent standards for written opinions under the regulations governing practice before the Service (commonly referred to as “Circular 230”).⁵⁸ These various ethical issues may exact a significant transaction cost for deals that are governed by one or more patents and may result in faulty compliance that undermines these rules.

Finally, a concern expressed by many commentators relates to the unique status of tax law as a mandatory system to which everyone is subject and with which all are expected to comply through a voluntary filing system. Because of the importance of voluntary compliance, and as a matter of fundamental fairness, the tax laws purport to treat equally-situated taxpayers the same. If a patent holder holds a patent on a central tax minimization strategy, it may be that some taxpayers will forego using the strategy rather than pay the royalty to do so. In the case of tax strategies that are straightforward realizations of the potential enacted by Congress in the tax code, tax patents (other than compliance and tax preparation software patents) appear particularly noxious because they essentially will result in a “toll charge” to taxpayers, undoing the tax savings that adherence to the Code provisions would otherwise provide. Patent holders would essentially be permitted to extract economic rent from other tax practitioners and taxpayers for routine tax planning. Some commentators consider this to amount to “privatization of the tax laws” that may “deny the taxpayers unrestricted access to the provisions of the Internal Revenue Code.”⁵⁹ “Privatization” of the tax

58. See 31 C.F.R. §§ 10.27, 10.29.

59. Weinsheimer & Grossman, *supra* note 48, at 14; John R. Thomas, *The Patenting of the Liberal Professions*, 40 B.C. L. Rev. 1139, 1165 (1999) (noting that *State Street Bank & Trust Co. v. Signature Financial, Inc.* involved a claim very closely worded after the applicable tax statute and regulations). *State Street Bank* involved partnerships of regulated investment companies and data processing methods that permitted daily and year-end determinations of each partner’s share of investment returns. *State Street Bank & Trust Co. v. Signature Financial Inc.*, 149 F.3d 1368 (Fed. Cir. 1998), *cert. denied*, 525 U.S. 1093 (1999).

laws calls into question the equitable treatment required under the tax laws and may cause taxpayers to blame the tax laws for the inequities, rather than the patent laws. The New York State Bar Association Tax Section expressed this concern bluntly: “We do not believe that it is sound policy to force taxpayers to choose between paying more tax than they are legally obligated to pay and paying royalties to a third party who has patented a tax strategy.”⁶⁰

Patents in these cases would be particularly offensive if no licenses were granted, thus excluding taxpayers from using the strategy. In an extreme case, if a patent holder is able to amass a portfolio of patents that effectively “corners the market” on particular types of transactions or activities and subsequently refuses to license those strategies to competitors, Congress will have limited ability to direct economic activity through legislation. Patent holders will have enormous power over other taxpayers’ ability to comply with the tax laws; the situation would be equivalent to “government issued barbed wire.”⁶¹ It is even possible that refusals to license could result in taxpayers being unable to benefit from a subsidy intended by Congress for particular types of business. One example would be where the patent related to a new provision of the Code that established a tax incentive and there was, for all practical purposes, no other manner of satisfying the provision than through the process set out in the patent claims. In each case, the existence of a tax strategy patent undermines the voluntary compliance system that is the backbone of the federal income tax.

It is possible that the negative picture drawn here misses some benefits of the patent system unique to tax. There are two main benefits that could accrue to a tax strategy patent system: earlier notice to the Service of aggressive strategies and higher transaction costs that discourage some aggressive tax planning.⁶² Regarding the notice issue, some commentators have argued that the disclosure of

60. New York State Bar Association Tax Section, *Patentability of Tax Advice*, at 2 (Aug. 17, 2006).

61. Paul Devinsky et al., *Whose Tax Law Is It? Alarm Bells Should Ring Over Rising Efforts to Patent Tax Strategies*, *Legal Times*, Oct. 16, 2006.

62. See, e.g., Burk & McDonnell, *supra* note 14, at 14-15.

many patent applications after eighteen months, and of all issued patents, will help the Service discover state-of-the art tax planning strategies more quickly, permitting it to respond to and stifle super-aggressive transactions at an earlier stage. This would be true particularly if Congress amended the Patent Act to permit the USPTO to confer with the Service about particular applications or to share any tax strategy applications with the Service *ab initio*, although it could be hindered by the USPTO's inability to appropriately categorize an application as dealing with a tax planning strategy.⁶³ The Service's proposed regulations requiring reporting of patented transactions also directly address the notice issue, to the extent that compliance can be assured.⁶⁴

Paying royalties to use tax strategies may discourage some taxpayers, but it is likely that the typical taxpayer willing to hire tax advisers to devise a tax-minimization strategy for a transaction would be ready to pay the additional licensing fee if there was still a net gain from tax minimization. The reduced tax savings might act to discourage a few taxpayers at the margin (resulting in the inequities discussed above), but it would not be expected to have a significant impact on tax minimization practices.

IV. GLOBALIZATION AND THE TREND TOWARDS INTELLECTUAL PROPERTY LAW HARMONIZATION

In our increasingly integrated, high technology, global economy, inventions are not easily contained within national jurisdictions.⁶⁵ There is growing demand for patent protection across jurisdictions and concern that a patent granted in one jurisdiction will not be sufficient to protect inventors' interests. Seeking additional patent protections in other jurisdictions, however, can add considerable complexity and greatly increase transaction costs without

63. See *supra* note 47. This, of course, presents the problem of which type of law is superior. Does patent law preempt tax law, or does tax law preempt patent law?

64. See *supra* note 47 and accompanying text.

65. Melissa Feeney Wasserman, *Divided Infringement: Expanding the Extraterritorial Scope of Patent Law*, 82 N.Y.U. L. Rev. 281, 281-283 (2007).

an internationally recognized patent system. Differences in national laws affect ownership of the patent and what post-issuance remedies may exist.⁶⁶

Although there is currently no global patent system, the move towards intellectual property law harmonization includes patent developments. The TRIPS agreement provides a broad statement about global protection for inventions (including processes). Despite TRIPS, there are a number of persisting differences in U.S. patent law and international standards, including first-inventor-to-file-priority, application disclosure, prior user rights, and post-issuance opposition short of litigation. Current patent reforms in the United States Congress specifically address a number of these issues in order to harmonize U.S. patent law more closely with prevailing international law.⁶⁷

As for our particular topic here—the question of the validity of tax strategy patents as a sub-category of business method patents, there is considerable disagreement about the interpretation of the obligation under TRIPS Article 27.1, which requires that signatory nations provide protection for “any inventions, whether product or processes, in all fields of technology.”⁶⁸

The USPTO views its obligations under the TRIPS agreement as demanding nondiscrimination among various subject matters.⁶⁹ The

66 Schacht & Thomas, *supra* note 22, at 8.

67. *See, e.g.*, Patent Reform Act of 2007, S. 1145, 110th Cong. (2007)(introduced by Senators Leahy and Hatch); Patent Reform Act of 2007, H.R. 1908, 110th Cong. (2007). The current U.S. system awards patents to the first to invent, but European patents are awarded to the first to file. Should this bill be enacted, the U.S. patent system would comport with the European requirements, causing some to question whether small inventors will be more easily squeezed out of the system because of lesser resources and the possibility of corporate espionage.

68. *See supra* note 2.

69. *See, e.g.*, Karen Ferriter, *Overview of U.S. Patents: TRIPS and U.S. Patent Examination* (U.S. Patent and Trademark Office, Nov. 2, 2007), available at http://www.uspto.gov/web/offices/dcom/olia/conf_gipa2007nov2/trips_and_patents.ppt#291,1, OVERVIEW OF PATENTS: TRIPS and US PATENT EXAMINATION (describing TRIPS’ non-discrimination provision and equating TRIPS’ requirements with the US court’s test); U.S. Patent and Trademark Office, “*Request for Comments*

nondiscrimination claim is that the treaty requires all member nations' patent systems to be technology-neutral in approving patents and prohibits amendments to the U.S. Patent Act that would create patent-free subject matter areas.⁷⁰ If patents are issued, the TRIPS agreement requires the full panoply of remedies. One commentator therefore suggests that Congress's recent amendment to the Patent Act permitting patents of medical methods but not permitting enforcement actions may not be in compliance with TRIPS.⁷¹ In addition, commentators have argued that traditional U.S. patent principles and general international concepts of patents do not support carving out business or legal process methods as ineligible for patents.⁷² If the

on the International Effort to Harmonize the Substantive Requirements of Patent Laws", Mar. 19, 2001 Fed. Reg. 15409-15411 (stating that the technological requirement in other countries' patent laws is more restrictive than the "useful, concrete, and tangible" test applied under U.S. patent law). Brian Kahin reported in comments on the 2001 roundtable patent discussions that the U.S. government was insisting that "patents should be available for any fields, not just technology" and was threatening to walk out of discussions if other countries didn't agree. Brian Kahin, *Comments Concerning Institutional Roles at the October 25 Roundtable*, available at <http://www.ftc.gov/os/comments/intelpropertycomments/kahinsupp.pdf>.

70. See, e.g., Browyn Hall, *Business Method Patents, Innovation and Policy* (2003), available at <http://euro.ecom.cmu.edu/program/law/08-732/Patents/BusinessMethodPatents.pdf> (indicating that the TRIPS agreement does not permit exclusion of business method patents, and citing B. Diallo, "Historical perspectives on IP protection for software in selected countries worldwide," 25 *World Patent Information* 19 (2003)). See generally Edita Petnycyte, *Should Patent Protection Be Extended to Business Methods*, 3 *Intern'l J. of Baltic Law* 114 (2004), available at www.ceeol.com (comparing and contrasting the U.S., European, and Japanese approach to business method patents).

71. See Thomas, *supra* note 59 at 1142 (suggesting that any effort to deny patentability to particular "spheres of activity" is "unlikely to succeed"). *But see* 35 U.S.C. §287(c) (1999) (Physicians Immunity Statute generally denies damages or injunctive relief against licensed medical practitioners or related health care facilities).

72. See, e.g., Gregory J. Maier, *An "Opposition" to the Recently-Proposed Legislation Related to Business Method Patents*, 20 *J. Marshall J. Computer & Info. L.* 397, 412 (2002); Symposium, *Do Overly Broad Patents Lead to Restrictions on Innovation and Competition?*, 15 *Fordham Intell. Prop. Media & Ent. L.J.* 947, 957-58 (2005) (quoting Mary Critharis of the USPTO); John A. Squires & Thomas S.

United States ultimately concludes that the TRIPS agreement requires the patenting of business methods or tax strategies, there may be increased pressure on U.S. trading partners to adopt similar protections, as in the case of bilateral agreements for protection of copyrighted subject matter.⁷³

Differing perspectives exist in which other commentators have suggested that the TRIPS language should not be read so broadly as to include business methods and legal processes. The nature of the process, in the case of business methods and legal processes, does not appear to be the kind of industrial application that was intended to be covered by the TRIPS agreement or, indeed, by the “useful Arts” language of the U.S. Constitution. Business methods relate to commercial activities rather than to the technology fields referenced in the TRIPS agreement; therefore, they should be excludible as a result of their ineligible subject matter for patents.⁷⁴ Accordingly, John Thomas suggests that patents should be restricted to industrial applications by patenting only “advances to the repeatable production or transformation of material objects.”⁷⁵ In fact, many of the developed countries have attempted to draw the line at patenting business methods based on similar arguments about suitable subject matter.⁷⁶ The European Patent Convention grants patents for

Biemer, *Patent law 101: Does a Grudging Lundgren Panel Decision Mean That the USPTO is Finally Getting the Statutory Subject Matter Question Right?*, 46 *Idea* 561, 562 (2006) (arguing that any technological arts requirement is bogus and business methods should be patentable).

73 See, e.g., Australia-US Free Trade Agreement, art. 17.4.5, May 18, 2004, available at http://www.ustr.gov/assets/Trade_Agreements/Bilateral/Australia_FTA/Final_Text/asset_upload_file469_5141.pdf (the section on intellectual property grants protections to copyrighted subject matter similar to those provided in the Digital Millennium Copyright Act).

74. See Drennan, *supra* note 54, 40-44, n. 194.

75. Thomas, *supra* note 59, at 1143, 1178-79 (noting that Europe and Japan rely on industrial applications to limit patent subject matter). But note that the USPTO has moved in the opposite direction, issuing guidelines in late 2005 that effectively eliminated its “technological arts” standard for patent issuance. See Joint Committee on Taxation, *supra* note 49, at 9.

innovations that are “susceptible of industrial application.”⁷⁷ The Convention specifically excludes specific types of subject matter relating to “schemes, rules and methods for performing mental acts, playing games or doing business, and programs for computers”: the exclusions cannot be avoided merely by including an additional feature that is not within the enumerated exclusions.⁷⁸ The substance of the invention must be technical to make the invention eligible for patent protections.

As a result of these current restrictions abroad, U.S. companies have a competitive advantage, at least as far as using patented business method processes domestically. For example, U.S. law imposes a higher barrier to competition than the patent law of other developed countries. Tax practitioners, however, spend a considerable amount of time developing cross-border transaction structures. It is logical to anticipate that if domestic patents continue to be approved and become more commonplace, tax practitioners will lobby for patentability abroad in order to achieve consistent protection for all elements of the cross-border tax strategies. This may create pressure on U.S. trading partners to permit patenting of business, legal and tax methods. Consequently, some commentators believe that the practice in other countries towards business method patents will change over time.⁷⁹

76. See, e.g., Paul Goldstein, *International Intellectual Property Law* 308-09 (2001) (discussing the 1973 European Patent convention Article 52(2), which indicates that business methods are not eligible subject matter for patents) (discussed in Drennan, *supra* note 54, at 42, n. 99); Jeffrey E. Young, *Patenting of Financial Business Methods Gains Momentum*, 11 Elec. Banking L. & Com. Rep. 12 (2006) (indicating that the European and Japanese Patent Offices will not patent business methods per se, and require computer-implemented business process to have technical features, and also noting some lack of clarity as to what sorts of claims will be considered by the Canadian Patent Office).

77. European Patent Convention, art. 52(1) (2000), available at <http://www.epo.org/patents/law/legal-texts/html/epc/2000/e/ar52.html>.

78. European Patent Convention, art. 52(2)(c) and art. 52(3) (2000).

79. See Young, *supra* note 76, at 5 (noting that many other countries permit delays in application that might make it worthwhile to await developments in business method application approvals).

V. IMPLICATIONS OF TAX STRATEGY PATENTS FOR GLOBALIZED MARKETS

Economic analysis can shed light on the relative benefit of issuing patents on tax planning technologies, especially in the international context. Will tax strategy patents encourage or discourage engagement in productive cross-border activity? Will patents encourage or discourage useful innovation that will permit businesses to more easily transact across borders? Will patents encourage or discourage market concentration? Are there concerns in the international context about privatization of methods of compliance with tax laws that override whatever advantage there may be to accelerate innovation of tax-advantageous international transaction structures? Many of the domestic problems for tax strategy patents have global counterparts that may be intensified in the international context.

First, it seems clear that the policy of fostering innovation is as questionable in the international context as in the domestic one. The cadre of tax practitioners who advise on advantageous tax structuring for cross-border deals are already among the elite in the field and enjoy strong reputations for their expertise in corporate structure, dividend and consolidation requirements, and withholding rules of various jurisdictions. They are required to familiarize themselves with the relevant tax laws in a number of jurisdictions, and develop tax minimization strategies that take into account both U.S. and foreign tax laws, especially for cross-border acquisitions and reorganizations. Their reward is their reputation for understanding the international context and the clients and fees that follow. Perhaps even more than in the purely domestic context, cross-border tax innovations are readily available, widely shared among tax practitioners at conferences and seminars, and amply rewarded in the marketplace. Thus, the need for patents to create incentives for innovation in this area is particularly lacking.

If most countries permit tax strategy patents, it is likely that those strategies will fall both within the routine and the super-aggressive types that are currently at issue in the United States. To the extent that the innovation involves acceptable means of complying with all applicable laws, universal granting of tax strategy patents is

particularly worrisome in the cross-border context. In cross-border deals, there may be a more limited number of reasonable ways for enterprises to structure various kinds of transactions, such as spin-offs, stock acquisitions, and other types of reorganizations in order to operate efficiently in various jurisdictions within a suitable tax structure. Patents on those limited means will at the least add to the transactional costs of undertaking a cross-border deal.

The cross-border context enhances the ability of patent trolls to control access to legal methods of structuring transactions. If a patent holder monopolizes those strategies by failing to grant licenses to competitors, it may permit the patent holder to enjoy an enormous competitive advantage that unfairly skews the marketplace in the patent holder's favor.⁸⁰ Smaller potential competitors may find the marginal increase in costs of engaging in the transaction sufficient to turn a potential profit into a loss. Larger competitors may choose to restructure through alternative, "second-best" strategies, but still incur significantly higher costs, impeding competition with the patent holder. Similar concerns would apply for exit strategies, in that the patent holder might be able to cut its losses appropriately, but its main competitors might delay their exit too long due to their inability to use the most beneficial tax-saving strategy.⁸¹ As one commentator noted, "you don't compete by outlawing your competition."⁸² The deadweight loss to society from stifled competition may be significant, and the tax policies of both jurisdictions in the international transaction may be stymied.⁸³

80. Paul Devinsky et al., *To Practice Tax law, You Need a Patent License*, IPLaw360 (2006).

81. *Id.*

82. James Surowiecki, *Patent Bending*, *The New Yorker*, July 14, 2003, at 36, available at http://www.newyorker.com/archive/2003/07/14/030714ta_talk_surowiecki (last visited Feb. 25, 2007).

83. One feature of tax laws may make this doomsday scenario less likely. Tax laws tend to change much more rapidly than other legal systems—as economic conditions change or societies develop new competencies, legislatures and tax administrators tweak the tax laws to better suit the new environment. Thus, what is a good strategy worth patenting one year may become virtually useless a short time later. In effect,

The proliferation of tax strategy patent rights may also result in under-use of reasonable tax strategies for cross-border deals. If multiple patents for component structuring techniques are held by a disparate group of patentees in multiple jurisdictions, the entrepreneur planning a cross-border deal must undertake complex negotiations for multiple licenses. Since planning often has a number of false starts, there could be duplicative phases of such negotiations. The diverse patent holders could possibly demand excessive rents, while the multiple negotiations with patent holders in different jurisdictions would be more expensive to conduct and more likely to break down due to failures in communication or simply different market perspectives.⁸⁴ Highly fragmented rights, in other words, would likely result in very high transaction costs for negotiating a deal. This is the problem of the anti-commons—too many property rights, so that the commons itself is underutilized.⁸⁵ In the case of smaller companies or start-ups, the additional resource needs might tip the balance against carrying out the transaction.

Where the patent involves aggressive structuring or cross-border tax shelter planning, provision of the monopoly incentive offered by patent law may be even more inappropriate in a cross-border context than it is in a domestic context. Bilateral tax treaties attempt to provide reasonable policy results that reconcile the two

the rapid change of tax laws may limit the term of the patent monopoly and thus limit the negative effects otherwise likely from patenting tax strategies.

84. See Vincent Chiappetta, TRIP-ping Over Business Method Patents, 37 Vand. J. Transnat'l L. 181 (2004) (arguing that attempts to harmonize business method patents on the global stage is misguided, in part because savings in the cost of transactions will not be realized). See also John Gladstone Mills III, *A Transactional Patent Convention for the Acquisition and Enforcement of International Rights*, 84 J. Pat. & Trademark Off. Soc'y 83, 92-93 (2002) (noting the flip-side of this point with the high costs of acquiring patent protection and enforcing those patents in multiple jurisdictions).

85. See, e.g., Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition From Marx to Markets*, 111 Harv. L. Rev. 621, 624 (1998); Michael A. Heller and Rebecca S. Eisenberg, *Can Patents Deter Innovation? The Anticommons in Biomedical Research*, 280 Science 698 (1998) (discussing the ability of excessive rents to destroy innovation); Burk & McDonnell, *supra* note 14, at 12.

contracting jurisdictions. The general goal of such treaties is that business income should be taxed by one or the other jurisdiction—it should not be double-taxed, but it should not avoid taxation altogether. Patented tax strategies may attempt to exploit inconsistencies in the laws of both jurisdictions to achieve zero taxation.⁸⁶ It may be more possible to achieve such a result in the multiple-jurisdiction patented strategy context if the patent application procedures permit customizing the description of the strategy in ways that conceal rather than reveal the process. The possibility of monopoly awards for such harmful activities may well spur the creation of more evasive tax strategies, which in turn will continue to raise the visibility of the tax minimization norm. In spite of patent law's claims of enhancing disclosure of inventions, such patents would undermine the attempt by organizations such as the Organization for Economic Cooperation and Development (OECD), which has focused particularly on tax havens and information sharing to increase transparency of cross-border transactions.⁸⁷ The end result may be to elevate tax avoidance and erode the perceived importance of tax compliance.

The same concerns about the potential for issuance of poor quality patents exist in the international context as in the domestic context, with perhaps even more serious consequences. If patent protections for tax strategies become common across most of the jurisdictions in which multinational companies operate, it will mean a surge in patent applications and issuances across the board as companies attempt to get into a position in which they will not be denied access to advantageous strategies by competitors holding patents or in which they at least hold an arguably valid patent for similar strategies that can form a countersuit against any claim. As in

86. See Mariano Municoy, *Allocation of Jurisdiction on Patent Disputes in the Models Developed by the Hague Conference in Private International Law: Asymmetric Countries and the Relationship of Private Parties*, 4 Chi.-Kent J. Intell. Prop. 342, 374 (2005) (describing the forum shopping that takes place when jurisdictions have differing patent laws).

87. See, e.g., OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998), available at <http://www.oecd.org/dataoecd/33/0/1904176.pdf>; OECD, *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report* (2004), available at <http://www.oecd.org/dataoecd/60/33/30901115.pdf>.

the domestic case, it is likely that foreign patent offices will face difficult analysis and resource demands to review tax strategy patent applications. As poor quality patents are issued, patent litigation is likely to increase at a great cost to patent holders and patent infringers alike. There is perhaps a more substantial risk that the threatened costs of patent litigation will keep smaller companies from attempting to develop a similar tax strategy and may even pressure those companies to forego international expansion plans. The aggregate effect of these problems again may be to discourage participation of small companies and startups in the globalized markets, leaving the stage to the well-resourced multinationals that will resultantly have more control over market pricing because of the limited competition. The many patents issued may further confuse taxpayers who strive to comply with the law, because they may perceive patented strategies as producing the results claimed whether or not the strategies would be legitimate under the tax laws. That confusion could lead to poorer compliance with tax laws overall.

Another potential misuse of patents is further exaggerated in the cross-border context. Commentators note that companies can use cross-licensing agreements⁸⁸ as court-enforceable controls for cartel pricing. Without patents, competitors' efforts to form a cartel would likely fail, but with cross-licensing, license fees are used to punish cartel cheaters, resulting in monopolies that are wider in scope than the original patent protection intended.⁸⁹ Cross-licensing of tax strategy patents among a select group of companies could be used to control entry and exit into one or more national markets. If those companies also cross-license their operating business patents (e.g., business methods, manufacturing), they would have a formidable international cartel.⁹⁰

88. See Wikipedia, <http://en.wikipedia.org/wiki/Cross-licensing> (defining cross-licensing as the reciprocal provision of patent rights between parties each holding a patent whose use is desired by the other party, without payment of a fee or other royalty) (last visited May 3, 2008).

89. Olson, *supra* note 42, at 66.

90. *Id.*

The harms outlined above—additional transaction costs for all parties planning a cross-border transaction, proliferation of tax minimization strategies and possibly of tax shelter strategies at a cost to each jurisdiction’s fisc, concentration of industries through refusal to grant licenses, and further concentration through granting of many “bad” patents that permit patentees to establish a foothold earlier than their competitors—represent in some sense the ordinary costs for patent systems but writ large because of the way tax efficiencies influence all aspects of business structuring. The patent law assumes that the tradeoff for the spur to innovation is the grant of a monopoly and the potential blow to competitiveness that grant provides, but it also assumes that the accelerated benefit of the invention, the relatively short period of the monopoly (20 years), and the disclosure provided by patent publication will sufficiently counter those harms. Is there a sufficient difference of scale or nature here to justify the European position against business method patents, or does the cost-benefit balance favor the U.S. “anything goes” position?

VI. CONCLUSION

In sum, acceleration of tax minimization strategies is not needed and is on balance much more likely to be harmful to society rather than beneficial. The 20-year period for a monopoly is an eon in tax terms—even a few years of delayed entry into a market because of tax disadvantages can lock in the competitive advantage of the monopolizer for years. The disclosure provided by the patent application may have some benefits to tax authorities, but it is not significantly more than they can currently require through reporting rules. It is unlikely to have much benefit to the public, since only those tax experts who already spend considerable time ferreting out the details of complicated tax provisions can reverse-engineer the complex strategies, and those are the ones already competing to be first to develop new loophole strategies. The rush to file a patent will likely lead to enormous consolidation of the firms that file tax strategy patents and similar concentration among industries where tax-advantageous structuring of multinational transactions is especially important. The proliferation of tax strategy patents will further erode public compliance, both because of the potential confusion engendered

by the issuance of many patents for invalid tax strategies and because of the heightened visibility of tax minimization strategies generally and the expansion of the tax minimization norm as an understanding of the proper approach to tax law. There simply appears to be no public benefit from offering tax strategy patents but considerable public detriment. The European position is the better one, and the United States would be well advised to harmonize its patent law with the European law in this respect, by requiring an industrial application for patentability