

Oklahoma Law Review

Volume 60 | Number 3

2007

The Patent Office is Promoting Shocking New Tax Loopholes-- Should the Empire Strike Back?

William A. Drennan

Follow this and additional works at: <https://digitalcommons.law.ou.edu/olr>



Part of the [Intellectual Property Law Commons](#), [Taxation-Federal Commons](#), and the [Tax Law Commons](#)

Recommended Citation

William A. Drennan, *The Patent Office is Promoting Shocking New Tax Loopholes--Should the Empire Strike Back?*, 60 OKLA. L. REV. 491 (2007),
<https://digitalcommons.law.ou.edu/olr/vol60/iss3/2>

This Article is brought to you for free and open access by University of Oklahoma College of Law Digital Commons. It has been accepted for inclusion in Oklahoma Law Review by an authorized editor of University of Oklahoma College of Law Digital Commons. For more information, please contact darinfox@ou.edu.

THE PATENT OFFICE IS PROMOTING SHOCKING
NEW TAX LOOPHOLES—SHOULD THE EMPIRE
STRIKE BACK?

WILLIAM A. DRENNAN*

Table of Contents

I. Introduction	492
II. The Patent Office Is Promoting Shocking New Tax Loopholes	496
A. Patents, Patentability, and the Idea Prohibition Doctrines	497
B. The Demise of the Idea Prohibition Doctrines	500
C. <i>State Street Bank</i> —A Process of Mental Steps that Generates a “Useful, Concrete and Tangible Result” Is Patentable	503
D. The Unforeseen Implications of <i>State Street Bank</i> and the Patentability of Tax Loopholes	506
E. The Patent Office Has No Authority to Deny Tax Strategy Patents After <i>State Street Bank</i>	509
III. Fundamental Policy Problems with Tax Loophole Patents	511
A. Increasing Complexity of the Tax Code	512
B. Tax Burdens Shift from the Super-Rich to Other Taxpayers	514
C. Taxpayer Morale Will Drop, Further Jeopardizing the Voluntary Compliance Tax System	517
D. Disparate Treatment of Similarly-Situated Taxpayers and Related Issues	522
IV. Congress Is Unlikely to Prohibit Tax Loophole Patents	524
A. The Pressure to Keep the U.S. Patent System “Technology- Neutral”	525
B. The Movement to Restrict Patent-Holder Rights in All Fields May Result in Special Tax-Strategy Patent Legislation Being Viewed as Premature	528
C. International Patent Law Considerations	530
V. How the Empire Should Strike Back	531

* Assistant Professor, Southern Illinois University School of Law; Member of the American Law Institute; LL.M. in Intellectual Property, Washington University (2003); LL.M. in Taxation, Washington University (1997); J.D., St. Louis University (1985). The author wishes to thank Christopher T. Polillo for his excellent research assistance.

A. The Treasury Has No Authority to Eliminate Tax Loophole Patents	531
B. The Treasury's Current Regulation of Contingent Fees Is Inadequate	539
C. The IRS Should Require that Taxpayers "Red Flag" Their Tax Returns and Provide Detailed Information If They Use a Patented Tax Strategy	542
VI. Conclusion	545

I. Introduction

The Patent Office,¹ inspired by a Federal Circuit case,² is issuing patents on shocking³ new tax loopholes. A patent effectively grants the inventor a 16-year monopoly on a tax loophole.⁴ The lure of patent protection will lead large financial service firms,⁵ and other tax experts,⁶ to search for tax loopholes with

1. Throughout this Article, the U.S. Patent and Trademark Office will be referred to as the "Patent Office."

2. *State St. Bank & Trust Co. v. Signature Fin. Group*, 149 F.3d 1368 (Fed. Cir. 1998).

3. While the term "shocking" does not appear in the patent statutes, if an invention would be "obvious . . . to a person having ordinary skill in the art," it cannot be patented. 35 U.S.C. § 103(a) (2000). It is not necessary that the inventor exclaim "eureka" upon making the discovery. *See id.* ("Patentability shall not be [negated] by the manner in which the invention was made."). Nonetheless, the combination of the various elements that make up the invention cannot have been anticipated by prior published authorities. *See infra* notes 96-102 and accompanying text.

4. A patent holder can prevent others from using, selling, offering to sell, or importing the patented invention, 35 U.S.C. § 271(a), beginning on the date the Patent Office issues the patent, "and ending [on the date] 20 years from the date on which the patent application was filed . . ." 35 U.S.C. § 154(a)(2) (emphasis added) (for patent applications filed after June 8, 1995); *Brenner v. Manson*, 383 U.S. 519, 534 (1966) ("granting a patent monopoly"). Since the Patent Office, on average, has not taken an "office action" on a tax strategy patent application until four years after the patent application is filed, the effective duration of the monopoly on a tax strategy would be approximately sixteen years. *See Hearing on Issues Relating to the Patenting of Tax Advice: Hearing Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways & Means*, 109th Cong. 9 (2006) [hereinafter *Patenting of Tax Advice Hearings*] (statement of James Toupin, General Counsel, U.S. Patent and Trademark Office), available at http://frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.181&filename=30450.pdf&directory=/disks/wais/data/109_house_hearings.

5. The Patent Office has designated Classification 705/36T for tax patents. *See* U.S. PATENT & TRADEMARK OFFICE, CLASS 705 DATA PROCESSING 705-2 (2005), available at <http://www.uspto.gov/go/classification/uspc705/sched705.pdf>. Patents in this classification have been issued to: Marshall & Ilsley Corp., U.S. Patent No. 7,031,937 (filed Jan. 18, 2002); Goldman, Sachs & Co., U.S. Patent No. 6,766,303 (filed Oct. 15, 2001); J.P. Morgan Advisory Services, U.S. Patent No. 7,031,935 (filed July 31, 2000); The Guardian Life Insurance Co. of America, U.S. Patent No. 7,016,871 (filed July 25, 2000); Marshall & Ilsley Corp., U.S. Patent

unprecedented zeal.⁷ They will invent, develop, and market schemes that Congress never imagined. This will create serious policy problems that have thus far been ignored.⁸

First, patented tax loopholes will shift tax burdens from the super-rich to all other taxpayers, including the middle-class and the poor.⁹ In search of more profits for themselves, powerful financial service firms and other tax inventors will pour their research dollars into developing loopholes that can save the super-rich big money.¹⁰ Because the super-rich have the most income and

No. 6,687,681 (filed May 28, 1999); and Merrill Lynch, Pierce, Fenner & Smith, U.S. Patent No. 6,108,641 (filed Oct. 14, 1998). Although the Patent Office assigns “tax patents” to Classification 705/36T, many of the patents in that category reflect business or investment techniques, and tax savings are not a major incentive for many of these techniques.

6. Attorneys, CPAs, and other tax experts likely will join in the rush to patent. An attorney for Millbank Tweed, a New York law firm with approximately 550 attorneys, *see* Millbank Home Page, <http://www.milbank.com/en> (last visited Aug. 8, 2007), has submitted at least five patent applications for tax saving inventions. *See, e.g.*, Apparatus & Method for Implementing and/or Administering a Wealth Transfer Plan, U.S. Patent Application No. 20,030,105,701 (filed June 5, 2003); Method and Apparatus for Establishing & Administering a Charitable Gift Transfer Plan, U.S. Patent Application No. 20,030,105,690 (filed June 5, 2003); Method & Apparatus for Transferring Wealth, U.S. Patent Application No. 20,030,105,691 (filed June 5, 2003); Wealth Transfer Plan Using in Kind Loan Repayment with Term Insurance Protection, U.S. Patent Application No. 20,030,130,939 (filed July 10, 2003); Wealth Transfer Plan Using in Kind Loan Repayment with Term Insurance Protection for Return of Note, U.S. Patent Application No. 20,030,130,935 (filed July 10, 2003).

7. *Patenting of Tax Advice Hearings*, *supra* note 4, at 25 (statement of Professor Richard S. Gruner) (“[P]atents 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.”); *see also id.* (“[I]f a firm can develop a sophisticated new tax planning strategy . . . 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.”).

8. At the *Patenting of Tax Advice Hearings*, speakers raised various concerns, but did not discuss the potential tax burden shift from the super-rich to other taxpayers, or the impact on voluntary compliance. *See id.*

9. For these purposes, the “super-rich” or the “wealthy” would be those taxpayers most likely to pay royalties in order to license tax loopholes to save big tax dollars. Also, many “poor” persons pay no income tax, so their taxes would not increase. For example, for 2007, a married couple filing jointly with gross income of less than \$17,500 would pay no income tax because of the standard deduction and combined personal exemptions. *See* 2007 RIA FEDERAL TAX HANDBOOK ¶ 3112 (2006) (stating that for the year 2007, the standard deduction for a married couple filing jointly is \$10,700); *id.* ¶ 3115 (stating that for the year 2007, the personal exemption is \$3,400 per person).

10. Several of the tax strategy patents issued, and the pending patent applications, attempt to save *estate taxes*. *See infra* note 139. Estate taxes only apply if the decedent’s gross estate exceeds a threshold amount (\$2 million for individuals dying in 2007 and 2008, and \$3.5

wealth to shelter from taxation, they can afford to pay the biggest royalties. This will accelerate a familiar phenomenon. When Congress enacts a new tax law, powerful financial service firms and other tax experts find new loopholes for the wealthy;¹¹ as Congress attempts to close the loopholes by amending the tax statutes, the wealthy and their advisors find different loopholes, and the process continues. As a result, the tax laws become more complex, and eventually tax laws are enacted that result in higher taxes for other taxpayers.¹²

Second, patented tax loopholes may act to accelerate the trend of decreasing compliance with tax laws, a dangerous downward spiral that threatens the foundations of the U.S. tax system. Patented loopholes will make the tax laws more complex. Greater complexity means greater frustration for taxpayers.¹³ Taxpayers will need to rely even more on tax professionals¹⁴ to comply with the tax laws, and to avoid paying excess taxes. Taxpayers will consider the U.S. tax system more unfair and arbitrary. This is dangerous because the U.S. tax system depends on voluntary compliance.¹⁵ As taxpayer morale drops, fewer taxpayers will comply with their U.S. tax obligations, and instead will engage in tax evasion schemes, such as offshore tax gimmicks,¹⁶ barter transactions,¹⁷ and other similar underground tax strategies¹⁸ to intentionally stay “beneath the radar” of U.S. tax authorities. The legislative history for the Jumpstart Our Business Strength (JOBS) Act states that “hundreds of thousands” of U.S. taxpayers may already be using offshore bank accounts to

million for individuals dying in 2009), I.R.C. § 2010(c) (Supp. IV 2004), and applies at a very high rate (the maximum rate in 2007 and 2008 is 45%). *Id.* § 2001(c)(2)(B). As a result, estate taxes only apply to wealthier taxpayers, and can extract substantial wealth from high net worth families. Accordingly, financial service firms and other tax inventors looking to make huge profits by patenting loopholes can be expected to focus on estate taxes.

11. *See infra* notes 133-34 and accompanying text.

12. *See infra* notes 147-50 and accompanying text.

13. *See infra* notes 151-70 and accompanying text.

14. One commentator states, “Filing a tax return no longer links the American people to their government. Instead, it is just one more commercial operation. H&R Block, Jackson-Hewitt, TurboTax, and a legion of accountants sit between Americans and their government.” Michael J. Graetz, *Taxes That Work: A Simple American Plan*, 58 FLA. L. REV. 1043, 1046 (2006).

15. *See infra* notes 155-63 and accompanying text.

16. *See infra* note 19.

17. *See* Rev. Rul. 79-24, 1979-1 C.B. 60.

18. *See* I.R.S. News Release IR-2004-19 (Feb. 10, 2004), available at <http://www.irs.gov/pub/irs-news/ir-04-019.pdf> (discussing abusive trusts, and employee leasing schemes); I.R.S. News Release IR-2003-18 (Feb. 19, 2003), available at <http://www.irs.gov/newsroom/article/0,,id=107493,00.html> (discussing nationwide tax scams, including improper home-based businesses).

hide income from the IRS.¹⁹ This lack of voluntary compliance with the tax laws is considered a major crisis, referred to as the “tax gap.”²⁰ The tax gap measures the difference between what taxpayers should pay, and what they actually pay,²¹ and has been estimated at over \$300 billion annually.²² Patented loopholes will reduce voluntary compliance, increase the tax gap, and place greater tax burdens on honest taxpayers who comply with their U.S. tax obligations.

Congress is unlikely to amend the patent statute to prohibit tax strategy patents because of pressure to keep the U.S. patent system “technology-neutral.”²³ If every industry could successfully lobby Congress to enact industry-specific patent statutes, the patent system would become extremely complex, and potential investors would be less likely to finance the development and production of patented products. Furthermore, Congress is

19. The legislative history states:

The [Senate] Committee understands that the number of individuals involved in using offshore bank accounts to engage in abusive tax scams has grown significantly in recent years. For one scheme alone, the IRS estimates that there may be hundreds of thousands of taxpayers with offshore bank accounts attempting to conceal income from the IRS.

S. REP. NO. 108-192, at 108 (2003), available at http://frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.183&filename=sr192.pdf&directory=/diska/wais/data/108_cong_reports.

20. I.R.S. Fact Sheet FS-2005-14 (Mar. 2005), available at <http://www.irs.gov/newsroom/article/0,,id=137246,00.html> (“The tax gap measures the extent to which taxpayers do not file their tax returns and pay the correct tax on time.”).

21. *Id.* (“The Internal Revenue Service developed the concept of the tax gap as a way to gauge taxpayers’ compliance with their federal tax obligations.”).

22. *Id.* (“The 2001 tax gap . . . is from \$312 billion to \$353 billion for all types of taxes.”).

23. Three bills would prohibit the issuance of tax-strategy patents. See Stop Tax Haven Abuse Act, S. 681, 110th Cong. § 303 (2007); Patent Reform Act of 2007, H.R. 1908, 110th Cong. § 10 (2007); S. 2369, 110th Cong. § 1 (2007). Another bill would restrict the collection of damages. See H.R. 2365, 110th Cong. (2007). This Article sets forth several policy arguments condemning tax strategy patents. See *infra* Part III. Nevertheless, this Article also describes several structural considerations that likely will prevent Congress from acting. See *infra* Part IV; see also Linda Beale, Professor of Law, Wayne State Univ. Law Sch., ATaxingMatter: Tax Patents (July 18, 2007), http://ataxingmatter.blogs.com/tax/tax_patents/index.html (“There is a strong lobby for non-interference with patent office processes I suspect the patent reform bill will not have an easy road to enactment by the full Congress.”); Dan L. Burk & Brett H. McDonnell, *Patents, Tax Shelters, and the Firm 2* (Univ. of Minn. Law Sch. Legal Studies Research Paper Series, Research Paper No. 07-05, 2007), available at <http://ssrn.com/abstract=961749> (“[We] take the existence of tax planning patents as given, assuming that the die for such patents was cast well over a decade ago, and is unlikely to undergo a reversal at this late date. As a matter of U.S. patent law, the emergence of tax planning patents was probably inevitable and is almost certainly irreversible.” (emphasis added)).

considering several revisions of patent-holder rights,²⁴ and specific legislation to address problems in one particular area may be viewed as premature.

Because Congress likely will not act, the Treasury Department, which is charged with the sound administration of the tax laws,²⁵ should respond to the problem.

Part II of this Article describes the developments that have led the Patent Office to issue tax loophole patents. Part III discusses the fundamental policy problems which will likely emerge from these patents. Part IV explains why Congress is unlikely to enact special legislation to prohibit tax loophole patents. Part V describes the action the U.S. Treasury Department (the "Treasury") should take to address the concerns raised by tax loophole patents. If the Treasury attempts to prohibit tax inventors from obtaining or enforcing tax loophole patents, the effort will be futile because tax inventors could circumvent the rules.²⁶ Nevertheless, the Treasury can mitigate the negative consequences of tax loophole patents by requiring that taxpayers "red flag" any patented tax strategy they use on their tax returns.²⁷ This will provide information regarding the extent to which patented tax loopholes allow taxpayers to avoid the tax results anticipated by Congress. With this information, the Treasury and Congress can adjust the tax laws to appropriately balance tax burdens among the rich, the middle-class, and the less wealthy.

II. The Patent Office Is Promoting Shocking New Tax Loopholes

If not stopped, Patent Office actions will have dramatic impacts on taxpayer and government behaviors. A foundational change in patent law renders the Patent Office a tax loophole promoter. As of January 22, 2008, the Patent Office had issued sixty-one tax patents, and had disclosed 106 tax patent applications pending.²⁸ This section analyzes how patent law has been altered

24. *See infra* Part IV.B.

25. *See* Internal Revenue Serv., The Agency, Its Mission and Statutory Authority, <http://www.irs.gov/irs/article/0,,id=98141,00.html> (last visited Sept. 25, 2007) ("The [S]ecretary [of the Treasury] has full authority to administer and enforce the internal revenue laws and has the power to create an agency to enforce these laws."); *see also* I.R.C. § 7801 (2000). A Commissioner of the IRS is appointed to administer and supervise. *Id.* § 7803.

26. Basically, the Treasury only has statutory authority to regulate attorneys and CPAs who represent taxpayers in IRS audits. Thus, the Treasury cannot control a tax inventor who is neither a CPA nor an attorney. Also, the Treasury cannot regulate a CPA or an attorney who does not represent taxpayers being audited by the IRS. *See infra* Part V.A.

27. *See infra* Part V.C.

28. "[T]here is a category for business method patents (705) and a more recent subcategory for tax patents (36T)." STAFF OF JOINT COMM. ON TAXATION, BACKGROUND AND ISSUES RELATING TO THE PATENTING OF TAX ADVICE 14 (2006), available at <http://www.house.gov/>

to promote tax strategy patents and discusses the types of tax loopholes the Patent Office is promoting.

A. Patents, Patentability, and the Idea Prohibition Doctrines

A patent is an artificial device used by the government to manipulate the actions of participants in a free market economy.²⁹ Normally, in a free market economy, producers are free to produce the items they want to produce, and consumers are free to purchase the goods they want to purchase. The price of the good sold, and the quantity produced, is determined by the natural market forces of supply and demand.³⁰ However, it has long been recognized that in the absence of government protections, economic actors will often refuse to spend considerable time and money to develop new products unless some barrier exists to prevent potential competitors from simply copying the new innovation.³¹ For example, if ABC Company spends hundreds of millions of dollars to develop a new mouse trap, and then its competition can immediately

ject/x-31-06.pdf. The number of tax patents outstanding and pending tax patent applications can be found on the Patent Office website. See Dennis I. Belcher & Dana G. Fitzsimons Jr., *Tax Planners—Beware of Patented Estate Planning Techniques!*, PROB. & PROP., Nov.-Dec. 2006, at 24, 25 (“Check the USPTO web site, at www.uspto.gov/patft/index.html, for patents classified as tax strategies and search using the term ‘ccl/705/36T.’”).

The number of tax patent applications pending may be significantly higher. Generally, the Patent Office publicly discloses patent applications 18 months after filing, 35 U.S.C. § 122(b)(1)(A) (2000), but a patent applicant can request that the application not be disclosed as long as the invention “has not and will not be the subject of [a patent] application filed in another country, or under a multilateral international agreement, that requires publication of applications 18 months after filing” 35 U.S.C. § 122(b)(2)(B). Although “[v]irtually all patent systems [outside] the United States provide for 18 month publication,” DONALD S. CHISUM ET AL., *PRINCIPLES OF PATENT LAW* 111 (3d ed. 2004), presumably the great majority of tax loopholes used in the United States are designed to dodge the specific language in the Internal Revenue Code, and would have no value outside the United States. Thus, when a tax strategy applies to U.S. tax laws and the applicant does not seek patent protection in any foreign country, the applicant can file the non-disclosure request, and the public will not become aware that the patent application has been filed until the patent actually issues. Also, on average, patent applications on tax strategies have not received any “office action” by the Patent Office until forty-four months after the patent application was filed. *Patenting of Tax Advice Hearings*, *supra* note 4, at 9 (statement of James Toupin, Patent Office General Counsel). As of July 2006, the average was fifty months. *Id.* In other words, as of July 2006, the Patent Office was issuing first office actions on patent applications that were filed in May 2002. Thus, the number of patent applications on tax strategies that are actually pending may greatly exceed the numbers reported on the Patent Office website.

29. “[T]he patent system provides some incentive that would be present at sub-optimal levels absent the patent system.” CHISUM ET AL., *supra* note 28, at 66.

30. See PAUL A. SAMUELSON, *ECONOMICS* 61-63 (10th ed. 1976).

31. CHISUM ET AL., *supra* note 28, at 62-63.

copy the design of the new mousetrap, ABC Company will never be able to recoup its research and development costs. Accordingly, if there is no barrier to restrict competition, firms will not spend significant time and money to innovate.³² In the great majority of industries, new inventions provide many benefits for society as a whole (not just for the inventor), including improvements in the quality of life, new jobs, greater economic growth and an improved balance of trade for the nation.³³ Thus, patents are granted to encourage the production of something that could benefit society as a whole.³⁴ The United States has a long history of encouraging innovation by granting patents to new inventions which meet certain statutory requirements.³⁵

A patent grants the holder a monopoly from the date the patent is issued that lasts until the twenty year anniversary of the date the patent application was filed.³⁶ During this monopoly period, anyone who uses the patented process without the inventor's permission is guilty of infringing the patent.³⁷ This prevents any potential competitors from selling the same or an equivalent product³⁸ during the term of the patent. This will allow the patent holder to charge a higher price than would be possible if competition were present.³⁹ This higher price is called a "monopoly price."⁴⁰ The ability to charge a "monopoly price" allows the inventor to reap greater profits. The potential for

32. *Id.* at 66 ("[T]he original inventor will not be able to recoup the costs of invention, including risk, unless she is ensured 'an exclusive' on the product of her inventive effort. It is postulated that without this reward, the inventor might not invest in the inventive process.").

33. *See infra* notes 107-08 and accompanying text (discussing the traditional utilitarian justifications for the patent system).

34. CHISUM ET AL., *supra* note 28, at 66.

35. The U.S. Constitution empowers Congress "to promote the Progress of Science and [the] useful Arts . . ." U.S. CONST. art. I, § 8, cl. 8. "America's first patent statute [was] signed into law on April 10, 1790 by President George Washington." CHISUM ET AL., *supra* note 28, at 19.

36. *See supra* note 4 (discussing the duration of patent protection). Note that if the invention is not unique—if consumers can purchase other goods instead of the patented product, there is no monopoly. *See* CHISUM ET AL., *supra* note 28, at 61 ("For example, people will only buy better mouse traps if they cost less than cats. Therefore, the patent monopoly is a monopoly on only one particular solution to the problem . . .").

37. 35 U.S.C. § 271(a) (2000) ("[W]hoever without authority makes, uses, offers to sell, or sells any patented invention . . . during the term of the patent . . . infringes the patent.").

38. "[T]he scope of protection associated with a patent may be expanded beyond the literal wording of the claims under the doctrine of equivalents. Under the current formulation of the doctrine, [a] product or process that presents insubstantial differences from the [patented] invention will be judged an equivalent and therefore an infringement." ROGER E. SCHECHTER & JOHN R. THOMAS, PRINCIPLES OF PATENT LAW 305 (2004).

39. CHISUM ET AL., *supra* note 28, at 60 ("[T]he monopoly price for a good . . . is higher . . . than competitive levels.").

40. *Id.* at 61.

greater profits is intended to induce potential inventors to devote their time, money, and other resources to generate patentable items. Thus, if patent protection is made available in an industry, it promotes new innovation.⁴¹

Under U.S. patent laws, ideas are not patentable.⁴² The U.S. Constitution grants Congress the authority to issue patents to “promote the Progress of Science and [the] useful Arts.”⁴³ Several U.S. Supreme Court Justices have stated that issuing patents on ideas would “impede rather than ‘promote the Progress of Science and [the] useful Arts’”⁴⁴ Until 1998, this general rule was applied by the courts through at least four doctrines, which clearly prohibited patents on tax strategies. These doctrines will be referred to in this Article as the “Idea Prohibition Doctrines.” These four Idea Prohibition Doctrines were the business method doctrine, the mental steps doctrine, the algorithm doctrine, and the Freeman-Walter-Abele doctrine. Persuasive policy arguments supported the application of each of these four doctrines.

First, under the business method doctrine, a process constituting a way of doing business could not be patented because the patent could allow a single inventor to monopolize an entire industry.⁴⁵ For example, allowing one accountant to patent the method of accounting used in a particular industry would allow that accountant to become the sole producer in the entire industry.⁴⁶

Second, the mental steps doctrine preserved the rule that abstract ideas are not patentable. Under the mental steps doctrine, a process consisting of two or more abstract ideas (or mental steps involving “human calculation and judgment”) could not be patented.⁴⁷ In the absence of this doctrine, an inventor could circumvent the rule by simply combining multiple abstract ideas into a process. If a combination of abstract ideas could be patented, one inventor could monopolize multiple fields of endeavor that may be based upon

41. *Id.*

42. *Diamond v. Chakrabarty*, 447 U.S. 303, 309 (1980) (stating that “laws of nature, physical phenomena, and abstract ideas” are not patentable).

43. U.S. CONST., art. I, § 8, cl. 8.

44. *Lab. Corp. of Am. Holdings v. Metabolite Labs., Inc.*, 126 S. Ct. 2921, 2922 (2006) (mem.) (Breyer, J., dissenting from denial of certiorari); *see also* *Gottschalk v. Benson*, 409 U.S. 63, 67 (1972) (stating that “mental processes and abstract intellectual concepts are not patentable, as they are the basic tools of scientific and technological work”).

45. *State St. Bank & Trust Co. v. Signature Fin. Group*, 927 F. Supp. 502, 516 (D. Mass. 1996), *rev'd*, 149 F.3d 1368 (Fed. Cir. 1998).

46. For example, in *State Street Bank*, “Signature admits that it informed State Street that any data processing system designed to perform book accounting for a multi-tiered fund arranged in a Hub and Spoke configuration likely would infringe [Signature’s] [p]atent.” 927 F. Supp. at 506 (emphasis added).

47. SCHECHTER & THOMAS, *supra* note 38, at 41.

that abstract idea. “Because the claims of these patents were not tied to a discrete physical apparatus, courts made the [] judgment that technological progress would be better served by preserving these broad principles within the public domain.”⁴⁸

Similarly, the third doctrine—the algorithm doctrine—prevented a patent on a series of mathematical formulae, because a mathematical formula is simply another way of expressing an abstract idea.⁴⁹

Fourth, under the Freeman-Walter-Abele doctrine, a process, including a mathematical algorithm, must be “applied to or limited by physical elements or process steps,” to be patentable.⁵⁰ Thus, the Freeman-Walter-Abele doctrine prevented patents on abstract ideas by requiring physical elements or process steps.

B. The Demise of the Idea Prohibition Doctrines

Although the applicability of the Idea Prohibition Doctrines had been in decline for several years,⁵¹ two key factors triggered the destruction of the remaining Idea Prohibition Doctrines in 1998: (i) the rise of the Federal Circuit, and (ii) the computer software industry’s demand for patent protection. In 1982, Congress created the United States Court of Appeals for the Federal Circuit (“Federal Circuit”) as a specialty court to handle all patent appeals.⁵² While arguments can be made in favor of specialty courts,⁵³ it has been observed that these courts, consciously or unconsciously, will tend to rule

48. *Id.* at 42.

49. *See Gottschalk*, 409 U.S. at 71-72.

50. *Arrhythmia Research Tech., Inc. v. Corazonix Corp.*, 958 F.2d 1053, 1058 (Fed. Cir. 1992). The Freeman-Walter-Abele doctrine inspired patent applicants to emphasize any physical apparatus used in the process. *See SCHECHTER & THOMAS, supra* note 38, at 46 (“[T]he *Freeman-Walter-Abele* standard did little to answer the hard questions Rather, [it] encouraged patent drafters to circumvent the issue by including some sort of apparatus in their claims.”).

51. The mental steps doctrine did not play a significant role after the creation of the Federal Circuit in 1982. *See SCHECHTER & THOMAS, supra* note 38, at 42. One could argue, however, that when the mental steps involved mathematical formulae, the algorithm theory applied as an extension of the mental steps doctrine. The practical impact of the Freeman-Walter-Abele doctrine was greatly diminished by the Federal Circuit in *In re Alappat*, 33 F.3d 1526 (Fed. Cir. 1994).

52. Federal Courts Improvement Act of 1982, Pub. L. No. 97-164, 96 Stat. 25 (codified in scattered sections of 28 U.S.C.). The jurisdiction of the Federal Circuit is described in 28 U.S.C. § 1295 (2000). The goals in creating the Federal Circuit included greater stability and predictability in patent decisions, and to discourage and reduce forum shopping. H.R. REP. NO. 97-312, at 20-22 (1981); S. REP. NO. 97-275, at 5 (1981).

53. *See* H.R. REP. NO. 97-312, at 20-23; S. REP. NO. 97-275, at 5.

in ways that will increase the importance of their specialty.⁵⁴ As a result, a court composed of patent specialists could be expected to issue opinions that increase the importance of the patent system in the U.S. economy. Consistent with that theory, both the scope of patentable subject matter⁵⁵ and the power of patent holders,⁵⁶ have increased dramatically as a result of Federal Circuit actions.

The second, and perhaps more direct impact, was the relentless assault of the computer software industry on the Idea Prohibition Doctrines.⁵⁷ In 1972, the U.S. Supreme Court held that computer software was merely a set of mathematical algorithms, and therefore was not patentable.⁵⁸ But software

54. Commentators have stated:

The first of the dangers that had previously been seen in the creation of a specialized patent court was the danger of “tunnel vision.” Judges in such a specialized court might be unable to see the broader context in which firms operated. . . . In such a setting, critics feared, the patent judiciary and the lawyers who practiced before them might turn inward They might begin to see the patent system as an end in itself, without considering that it is one element of a broader economic system.

. . . [T]he judges may be swayed by a belief in the unique importance of the field. As Richard Posner has argued, judges in specialized courts may be particularly prone to identify with government programs. Put another way, they may be prone to be “captured” by those who benefit from the program.

ADAM B. JAFFE & JOSH LERNER, *INNOVATION AND ITS DISCONTENTS* 102-03 (2004) (footnotes omitted); *see also* SCHECHTER & THOMAS, *supra* note 38, at 18 (“[The] tribunal . . . arguably has a vested interest in a robust patent system.”); Steven Andersen, *Federal Circuit Gets Passing Marks to Date But There’s a Lot of Room for Improvement*, *CORP. LEGAL TIMES*, Mar. 2000, at 86.

55. SCHECHTER & THOMAS, *supra* note 38, at 18 (“All observers agree that the Federal Circuit has dramatically expanded the range of patentable subject matter . . .”).

56. *Id.* (“All observers agree that the Federal Circuit has . . . strengthened the patent grant”); *see also* CHISUM ET AL., *supra* note 28, at 26 (“The court ushered in a new approach . . . resulting in a significant strengthening of the patent grant . . .”). *But see* Donald R. Dunner, *A Non-Statistical Look at the Federal Circuit’s Patent Decisions: 1982-1998*, in CHISUM ET AL., *supra* note 28, at 37 (“[S]tudents of the court know that the court in recent years has been tightening up significantly on the scope of the doctrine of equivalents as [well] as expanding the reach of prosecution history estoppel, a double whammy militating against the interests of patent owners.” (footnotes omitted)).

57. Commentators summarize the development by noting that “one suspects that both the [Patent Office] and the courts grew weary of the relentless argumentation of a bar that has scant motivation to favor restraints upon the scope of patenting.” SCHECHTER & THOMAS, *supra* note 38, at 43-44; *see also* *Lyon v. Boh*, 1 F.2d 48, 50 (S.D.N.Y. 1924), *rev’d*, 10 F.2d 30 (2d Cir. 1926) (“[T]he antlike persistence of [patent] solicitors has overcome, and I suppose will continue to overcome, the patience of examiners, and there is apparently always but one outcome.”).

58. *Gottschalk v. Benson*, 409 U.S. 63 (1972).

developers pressed on, trying to secure intellectual property protection. As a preliminary step, they sought copyright protection,⁵⁹ and successfully lobbied for amendments to the Copyright Act which confirm that computer software is eligible for copyright protection.⁶⁰ As copyright protection is weaker than patent protection,⁶¹ software developers continued to battle for patent protection. Not surprisingly, the Federal Circuit was receptive to the argument to expand patentable subject matter.⁶² However, in the process of allowing

59. See *Whelan Assocs. v. Jaslow Dental Lab., Inc.*, 797 F.2d 1222 (3d Cir. 1986) (“It is well, though recently, established that copyright protection extends to a program’s source and object codes.”).

60. See 17 U.S.C. §§ 117, 512(i)(2), 1201(a)-(b) (2000).

61. “[T]he scope of protection afforded copyrights is narrower and less absolute than that given to patents.” Bruce Abramson, *Promoting Innovation in the Software Industry: A First Principles Approach to Intellectual Property Reform*, 8 B.U. J. SCI. & TECH. L. 75, 78 n.9 (2002) (quoting ROBERT P. MERGES ET AL., *INTELLECTUAL PROPERTY IN THE NEW TECHNOLOGICAL AGE* 23 (2d ed. 2000)). A copyright is infringed if a third-party copies the work, 17 U.S.C. §§ 501(a), 106(1), but if a third-party independently creates a copyrighted work, there is no copyright infringement. Ryan Vacca, *Design Patents: An Alternative When the Low Standards of Copyright Are Too High?*, 31 S. ILL. U. L.J. 325, 356 (2007) (“Copyright only protects one from copying. If one independently creates an identical work, then copyright infringement has not occurred.” (footnote omitted)). In contrast, independent creation is not a defense to patent infringement. 35 U.S.C. § 271(a) (2000); Lynda J. Oswald, *The Personal Liability of Corporate Officers for Patent Infringement*, 44 IDEA 115, 122 (2003) (“Even a person who independently creates and in good faith makes, uses, or sells a patented invention is automatically liable for patent infringement.”). Furthermore, although an individual or entity has a copyright to a literary or artistic expression, others can copy or otherwise use the copyrighted work if the elements of the “fair use” exception are satisfied. 17 U.S.C. § 107 (“[T]he fair use of a copyrighted work . . . for purposes such as criticism, comment, news reporting, teaching . . . , scholarship, or research, is not an infringement of copyright.”).

62. Prior to the creation of the Federal Circuit, the U.S. Supreme Court had concluded that computer software could be patented under certain circumstances. In *Diamond v. Diehr*, 450 U.S. 175 (1981), the inventor sought a patent for a process in which computer software monitored the temperature of rubber inside a press, and triggered the press to open when the rubber was properly treated. The Court held that the process was patentable, emphasizing the tangible physical items used in the process (including the thermometer, the press, and the door), rather than the use of the mathematical formula. *Id.* at 187. Thus, the U.S. Supreme Court opened the door slightly, but it was the Federal Circuit that later threw open the doors of the Patent Office for computer software innovations.

The Federal Circuit, in *In re Alappat*, considered a computer process that converted data reflecting variations in electrical current into a visual display that could be read easily. 33 F.3d 1526 (Fed. Cir. 1994). The Patent Office rejected Alappat’s patent application because any general purpose computer could have performed the calculation, and the Patent Office believed that, in substance, Alappat’s invention consisted of “abstract mathematical principles that were independent of the hardware platform capable of performing the claimed functions.” SCHECHTER & THOMAS, *supra* note 38, at 47. The Federal Circuit, however, concluded that the invention was patentable, stating that computer “programming creates a new machine, because

computer software patents, the Federal Circuit opened Pandora's Box, and tax loophole patents have emerged.

C. State Street Bank—A Process of Mental Steps that Generates a “Useful, Concrete and Tangible Result” Is Patentable

In 1998, the Federal Circuit decided the landmark case of *State Street Bank & Trust Co. v. Signature Financial Group*.⁶³ For bona fide business reasons, mutual funds wanted to “pool” their assets to permit joint investing.⁶⁴ However, this “pooling” would cause legal and practical problems if the administrator of each separate mutual fund could not promptly report the price of a mutual fund share each day.⁶⁵ To remedy this problem, Signature developed computer software⁶⁶ that could generate a share price for each mutual fund within one-and-a-half hours of the close of the major securities markets each business day. Signature was the assignee of the innovative software, and financial services giant State Street Bank argued⁶⁷ that the software was not patentable under the Idea Prohibition Doctrines.⁶⁸ The Massachusetts District Court applied the Idea Prohibition Doctrines consistently with prior court decisions, and held that Signature's computer software was unpatentable.⁶⁹ On appeal, the Federal Circuit eliminated the

a general purpose computer in effect becomes a special purpose computer once it is programmed to perform particular functions pursuant to instructions from program software.” *In re Alappat*, 33 F.3d at 1545 (emphasis added). *In re Alappat* was a significant breakthrough for software developers, although the Federal Circuit was still focusing on a particular tangible apparatus—a “new” computer—in order to conclude that software could be patented. The Federal Circuit's focus on a physical apparatus was terminated in *State Street Bank & Trust Co. v. Signature Financial Group*, which held that a “process” which creates a “useful, concrete and tangible result” can be patented. 149 F.3d 1368, 1373 (Fed. Cir. 1998).

63. 149 F.3d 1368.

64. The federal district court in *State Street Bank & Trust Co. v. Signature Financial Group* explained why the mutual funds wanted to pool their interests, stating that “[e]nabling mutual funds to pool their assets in this manner provides for economies of scale with regard to the costs of fund administration” 927 F. Supp. 502, 504-05 (D. Mass. 1996), *rev'd*, 149 F.3d 1368.

65. *Id.* at 505 (“Administering this structure requires a daily allocation of income, capital gains, and expenses or investment losses. The daily allocations are made on the basis of the [individual mutual fund's] percentage share in the total assets of the [combined] portfolio.”).

66. *Id.* (“The portfolio/fund accountant makes use of a personal computer . . . programmed with software . . .”).

67. Initially, State Street Bank attempted to negotiate a license to use the software with Signature, but the negotiations were unsuccessful. *Id.* at 506.

68. Both the trial court and the Federal Circuit discussed the mathematical algorithm doctrine, rather than the mental steps doctrine, likely because mathematical formulae were involved.

69. The United States District Court for the District of Massachusetts discussed the history of attempts to patent computer software, *id.* at 508-12, and concluded that Signature's software

Idea Prohibition Doctrines,⁷⁰ and concluded that any process which generates

failed to satisfy the second prong of the Freeman-Walter-Abele test which required the claimed invention to be applied to, or limited by, physical elements or process steps. *Id.* at 513.

Signature's invention . . . like other accounting methods, [] is designed to manipulate and record numbers. . . . Signature's data processing system does not "involve[] the transformation or conversion of subject matter representative of or constituting physical activity or objects." . . . A change of one set of numbers into another, without more, is insufficient to confer patent protection. The invention does nothing other than present and solve a mathematical algorithm and, therefore, is not patentable.

Id. at 514 (quoting *In re Schrader*, 22 F.3d 290, 294 (Fed. Cir. 1994)) (second bracketed alteration in original).

The district court also stated that the business method doctrine still had "continued validity," *id.* at 515, and emphasized the policy rationale for the business method doctrine.

If Signature's invention were patentable, any financial institution desirous of implementing a multi-tiered funding complex modelled on a Hub and Spoke configuration would be required to seek Signature's permission before embarking on such a project. This is so because [Signature's] [p]atent is claimed sufficiently broadly to foreclose virtually any computer-implemented accounting method necessary to manage this type of financial structure. Indeed, during licensing negotiations, Signature informed State Street that any data processing system designed to perform book accounting for a multi-tiered fund based on a partnership portfolio configuration would infringe the [Signature] [p]atent.

In effect, the [Signature] [p]atent grants Signature a monopoly on its *idea* of a multi-tiered partnership portfolio investment structure; *patenting an accounting system necessary to carry on a certain type of business is tantamount to a patent on the business itself*. Because such abstract *ideas* are not patentable, either as methods of doing business or as mathematical algorithms, the [Signature] [p]atent must fail.

Id. at 516 (emphasis added).

70. First, in regards to the algorithm doctrine, the Federal Circuit relied upon two of its prior decisions to conclude that "transformation of data . . . by a machine through a series of mathematical calculations" is patentable as long as it "constitute[s] a practical application of [a] mathematical algorithm, formula, or calculation[]." *State St. Bank & Trust Co. v. Signature Fin. Group*, 149 F.3d 1368, 1373 (Fed. Cir. 1998). Second, the Federal Circuit stated that "[a]fter *Diehr* and *Chakrabarty*, the Freeman-Walter-Abele test has little, if any [application]" *Id.* at 1374. Third, the Federal Circuit saved its sharpest criticism for the business method doctrine, stating, "We take this opportunity to lay this ill-conceived exception to rest" *Id.* at 1375. The court also stated that "[the business method exception] is . . . an unwarranted encumbrance to the definition of statutory subject matter in section 101, that [should] be discarded as error-prone, redundant, and obsolete."

Id. at 1375 n.10 (quoting *In re Schrader*, 22 F.3d 290, 298 (Fed. Cir. 1994) (Newman, J., dissenting)) (alterations in original). As a parting shot, the Federal Circuit stated, "Any historical distinctions between a method of 'doing' business and the means of carrying it out blur in the complexity of modern business systems." *Id.* at 1376 n.13.

Although the Federal Circuit in *State Street Bank* did not discuss the mental steps doctrine, commentators noted that "the mental steps doctrine [had] not played a significant role in patent

a “useful, concrete and tangible result” is patentable.⁷¹

After *State Street Bank*, an abstract idea, such as Einstein’s $E=mc^2$, remains unpatentable.⁷² However, once that abstract idea is combined with one or more other abstract ideas into a “process”⁷³ that generates “a useful, concrete and tangible result,” the process becomes patentable.⁷⁴ Consistent with the decision in *State Street Bank*, the Patent Office has issued guidelines providing that a process can be patented *even if it involves no tangible physical apparatus*.⁷⁵ The Patent Office has issued patents on (i) a sports move, (ii) a method of teaching, and (iii) a technique of psychological analysis.⁷⁶ One commentator has even argued that a criminal defense attorney should be able to patent an effective defense strategy under the *State Street Bank* approach (if it satisfies the other conditions for patentability).⁷⁷

law at least since . . . 1982.” SCHECHTER & THOMAS, *supra* note 38, at 42.

71. *State St. Bank*, 149 F.3d at 1373 (“Today, we hold that the transformation of data, representing discrete dollar amounts . . . constitutes a practical application of a mathematical algorithm, formula, or calculation, because it produces a useful, concrete and tangible result . . .” (internal quotation marks omitted)).

72. *Diamond v. Chakrabarty*, 447 U.S. 303, 309 (1980) (“Einstein could not patent his celebrated law that $E=mc^2$.”). 35 U.S.C. § 101 (2000) requires a “process, machine, manufacture, or composition of matter . . .” Thus, unless the abstract idea is combined with other elements to create a “process,” it is unpatentable. See *Diamond v. Diehr*, 450 U.S. 175, 187 (1981) (“It is now commonplace that an *application* of a law of nature or mathematical formula to a known structure or process may well be deserving of patent protection.”).

73. “The term ‘process’ means process, art or method, and includes a new use of a known process, machine, manufacture, composition of matter, or material.” 35 U.S.C. § 100(b).

74. *State St. Bank*, 149 F.3d at 1373.

75. INTERIM GUIDELINES FOR EXAMINATION OF PATENT APPLICATIONS FOR PATENT SUBJECT MATTER ELIGIBILITY 21 (2005), available at http://www.uspto.gov/web/offices/pac/dapp/opla/preognotice/guidelines101_20051026.pdf (“The tangible requirement does not necessarily mean that a claim must either be tied to a particular machine or apparatus or must operate to change articles or materials to a different state or thing.”); see also STAFF OF JOINT COMM. ON TAXATION, *supra* note 28, at 9. The Patent Office has requested comments on these interim guidelines. *Id.*

76. SCHECHTER & THOMAS, *supra* note 38, at 24 (citing Method of Putting, U.S. Patent No. 5,616,089 (filed Mar. 29, 1996); Method for Instruction of Golf and the Like, U.S. Patent No. 5,558,519 (filed July 29, 1994); Character Assessment Method, U.S. Patent No. 5,190,458 (filed Apr. 17, 1991)). The Patent Office has also issued patents on surgical techniques. See CHISUM ET AL., *supra* note 28, at 850-51. Federal law, however, prohibits collecting damages from a health care provider who infringes a patented surgical procedure. 35 U.S.C. § 287(c).

77. “If you can patent an interpretation of the tax law, why not patent anyone’s legal advice? . . . Then you could say people being prosecuted for murder can’t use a certain defense without paying a licensing fee.” Jeremy Kahn, *Is My Loophole Really Legit?*, FORTUNE, Sept. 4, 2006, available at http://money.cnn.com/magazines/fortune/fortune_archive/2006/09/04/8384710/index.htm (internal quotation marks omitted); see also John R. Thomas, *The Patenting of the Liberal Professions*, 40 B.C. L. REV. 1139, 1139 (1999) (“As we read with amusement

D. The Unforeseen Implications of State Street Bank and the Patentability of Tax Loopholes

State Street Bank helped establish that “patent protection is broadly available for computer-related inventions,”⁷⁸ but the opinion has consequences far beyond the computer software industry.⁷⁹ Before 1998, one could argue that a tension existed between the language of the patent statute that a “process” is patentable subject matter,⁸⁰ and the judicial doctrines that a process consisting of mental steps, mathematical algorithms, or a business method, cannot be patented. The Federal Circuit eliminated this tension⁸¹ by destroying the algorithm doctrine and the business method doctrine. After 1998, any process which meets the statutory requirements is patentable. The patent statute sets forth four basic requirements for obtaining a patent—statutory subject matter, utility,⁸² novelty,⁸³ and non-obviousness.⁸⁴

First, an invention must meet the “statutory subject matter” requirement. The statute allows a patent on a “process.”⁸⁵ *State Street Bank* allows a patent on a series of mental steps, as long as the process generates “a useful, concrete and tangible result,”⁸⁶ and holds that a share price which meets regulatory requirements is a useful, concrete and tangible result.⁸⁷ A tax strategy will be a process (consisting of mental steps), and a tax strategy that saves the client tax dollars will be a “useful, concrete and tangible result.” Thus, after *State Street Bank*, a tax strategy will meet the statutory subject matter requirement.

patent instruments claiming methods for swinging a golf club, treating cancer or administering a mortgage, we come to realize that the patent law seems poised to embrace the broadest reaches of human experience.” (footnotes omitted)).

78. SCHECHTER & THOMAS, *supra* note 38, at 41; *see also* AT&T Corp. v. Excel Commc’ns, Inc., 172 F.3d 1352, 1358 (Fed. Cir. 1999) (adopting the “useful, concrete, [and] tangible result” test).

79. *See* Thomas, *supra* note 77.

80. 35 U.S.C. § 101.

81. The Federal Circuit denied that the *State Street Bank* opinion changed the law. The court stated, “Since the 1952 Patent Act, business methods have been, and should have been, subject to the same legal requirements for patentability as applied to any other process or method.” *State St. Bank & Trust Co. v. Signature Fin. Group*, 149 F.3d 1368, 1375 (Fed. Cir. 1998).

82. 35 U.S.C. § 101 (“Whoever invents . . . any new and useful process . . . may obtain a patent therefor . . .”).

83. *Id.* § 102.

84. *Id.* § 103(a).

85. *Id.* § 101.

86. 149 F.3d at 1373 (internal quotation marks omitted).

87. *Id.*

Second, an invention must be “useful” to be patented.⁸⁸ It is extremely easy to meet this standard.⁸⁹ Many inventions that provide little practical benefit have met this “utility” requirement.⁹⁰ In fact, commentators have noted that Federal Circuit cases (and other authorities) have eviscerated both of the first two barriers to patent protection,⁹¹ so that as a practical matter, inventions need only meet the last two statutory requirements to obtain a patent—novelty and non-obviousness.

Third, an invention must be “novel” to be patented.⁹² An invention will be “novel” unless one item of prior authority—such as a book, article, or an existing patent—covers all the “claims” of the patent.⁹³ These items of prior authority are commonly referred to as items of “prior art.”⁹⁴ Thus, if a single item of prior art describes the process, an inventor cannot obtain a patent on the tax strategy.⁹⁵

Fourth, an invention will not be patentable if it would have been “obvious . . . to a person having ordinary skill in the art”⁹⁶ This has been

88. 35 U.S.C. § 101.

89. 1 DONALD S. CHISUM, CHISUM ON PATENTS § 4.01, at 4-4 (“The requirement is easily met with most mechanical devices and processes . . .”). In applying the “utility” standard, Patent Office “examiners [] simply confirm that the invention may be put to one plausible, real-world use. . . . The utility requirement merely sifts out utterly incredible inventions from the domain of patentability.” SCHECHTER & THOMAS, *supra* note 38, at 63.

90. The Patent Office has issued patents for boomerang bullets (the bullets could make a complete circle and hit the shooter); the helmet gun (the recoil could break the shooter’s neck); the combined gun and plow; and the combination umbrella and lightning rod. *See* William A. Drennan, *Charitable Donations of Intellectual Property: The Case for Retaining the Fair Market Value Tax Deduction*, 2004 UTAH L. REV. 1045, 1094-95 n.241 (2004).

91. CHISUM ET AL., *supra* note 28, at 847. In *State Street Bank*, the Federal Circuit stated, “The question of whether a claim encompasses statutory subject matter should not focus on *which* of the four categories of subject matter a claim is directed to . . . but rather on the essential characteristics of the subject matter, in particular, its practical utility.” 149 F.3d at 1375 (footnote omitted). Thus, *State Street Bank* effectively merges the “statutory subject matter” requirement into the “utility” requirement, and, as discussed above, the utility requirement is extremely easy to satisfy. *See supra* notes 88-90 and accompanying text.

92. 35 U.S.C. § 102.

93. *Id.*

94. CHISUM, *supra* note 89, § 3.02; STAFF OF JOINT COMM. ON TAXATION, *supra* note 28, at 9.

95. *Hybritech Inc. v. Monoclonal Antibodies, Inc.*, 802 F.2d 1367, 1379 (Fed. Cir. 1986).

96. 35 U.S.C. § 103(a). Prior to the 1952 Patent Act, the U.S. Supreme Court stated that an invention would only be patentable if it reflected a “flash of creative genius.” *Cuno Eng’g Corp. v. Automatic Devices Corp.*, 314 U.S. 84, 91 (1941). The 1952 Patent Act switched the focus to a hypothetical person having “ordinary skill in the art.” 35 U.S.C. § 103(a).

referred to as the “ultimate condition of patentability.”⁹⁷ “The person [having] ordinary skill [in the art] is a hypothetical person who is presumed to be aware of *all* the pertinent prior art.”⁹⁸ Mr. Phosita⁹⁹ “thinks along the line of conventional wisdom in the art and is not one who undertakes to innovate”¹⁰⁰ An invention will be “obvious” to Mr. Phosita if there is “some teaching, suggestion or incentive supporting the combination” of items that constitutes the invention.¹⁰¹ Thus, while the statute¹⁰² does not use the word “shocking,” the statute prevents inventions that would be obvious to Mr. Phosita from being patented.

Although the *State Street Bank* holding clearly allows for tax loophole patents, nothing in the opinion indicates that the Federal Circuit understood that it was authorizing the Patent Office to issue these new types of patents. While the entity created as part of the invention in *State Street Bank* was taxed in a particular way,¹⁰³ the tax structure was not a new invention,¹⁰⁴ and

97. See generally NONOBVIOUSNESS—THE ULTIMATE CONDITION OF PATENTABILITY (John F. Witherspoon ed., 1980).

98. *Custom Accessories, Inc. v. Jeffrey-Allan Indus., Inc.*, 807 F.2d 955, 962 (Fed. Cir. 1986) (emphasis added).

99. The term “person having ordinary skill in the art” is commonly known by the acronym PHOSITA, and this hypothetical “person” is often referred to as “Mr. Phosita.” See CHISUM ET AL., *supra* note 28, at 620 n.1.

100. *Standard Oil Co. v. Am. Cyanamid Co.*, 774 F.2d 448, 454 (Fed. Cir. 1985). In 2007, The U.S. Supreme Court made Mr. Phosita a bit more active—“[w]hen there is . . . market pressure to solve a problem and there are a finite number of identified, predictable solutions, [Mr. Phosita will] pursue the known options” *KSR Int’l Co. v. Teleflex, Inc.*, 127 S. Ct. 1727, 1742 (2007). Mr. Phosita will “pursue the known options . . . [and] [i]f this leads to the anticipated success, [the new product or process] is likely the product not of innovation but of ordinary skill and common sense,” and is thus not patentable. *Id.*

101. *In re Bond*, 910 F.2d 831, 834 (Fed. Cir. 1990) (quoting *Carella v. Starlight Archery & Pro Line Co.*, 804 F.2d 135, 140 (Fed. Cir. 1986)); see also *SmithKline Diagnostics, Inc. v. Helena Labs. Corp.*, 859 F.2d 878, 887 (Fed. Cir. 1988).

102. 35 U.S.C. § 103(a) (2000).

103. Under state law, the entity was a business trust, but it was taxed as a partnership. The Federal Circuit only referred to the tax aspects of the invention three times. See *State St. Bank & Trust Co. v. Signature Fin. Group*, 149 F.3d 1368, 1370 (Fed. Cir. 1998) (“This investment configuration provides the administrator of a mutual fund with the advantageous combination of economies of scale in administering investments coupled with the tax advantages of a partnership.”); *id.* at 1371 (mentioning “tax” twice).

104. Signature’s process involved a pooling of investments of several different mutual funds into one entity, referred to as a “hub and spokes” arrangement in which the individual mutual funds were the “spokes” and the entity holding the pooled investments is the “hub.” *Id.* at 1370. The hub was a business trust under applicable state law, and was taxed as a partnership for federal income tax purposes. See *State St. Bank & Trust Co. v. Signature Fin. Group*, 927 F. Supp. 502, 504 (D. Mass. 1996). IRS rulings confirm that a business trust can be taxed as a partnership. See I.R.S. Priv. Ltr. Rul. 200517020 (Apr. 29, 2005); I.R.S. Priv. Ltr. Rul. 9641007

the Federal Circuit opinion includes no discussion of the patentability of tax saving strategies. The Patent Office did not classify the patent considered in *State Street Bank* as a tax strategy patent, but rather as a business method in a different subcategory.¹⁰⁵ Commentators point out that the *State Street Bank* opinion will permit patents to issue on all sorts of inventions that were never patentable before.¹⁰⁶ There is no indication that the Federal Circuit considered what might be inside before opening Pandora's Box.

Allowing patents on tax strategies is very different from allowing patents on computer software. As an initial matter, the potential policy arguments that support computer software patents are inapplicable to tax loophole patents. It may be argued that the traditional utilitarian policy rationales for providing patent protection generally apply to computer software—strengthening the U.S. economy, improving the U.S. balance of trade,¹⁰⁷ “enhanc[ing] the quality of life for all Americans and . . . [creating] new industries and jobs.”¹⁰⁸ However, these policy rationales do not apply to encouraging the invention of more tax loopholes. Tax loopholes shift tax burdens among classes of taxpayers rather than providing a net benefit.¹⁰⁹ While tax patents may create jobs for tax inventors and government personnel who try to close loopholes, one can question whether adding those jobs is worth the societal costs discussed in this Article.¹¹⁰ Tax loopholes will save tax dollars for the super-rich,¹¹¹ and more tax loopholes will not enhance the U.S. economy or improve the U.S. balance of trade.

E. The Patent Office Has No Authority to Deny Tax Strategy Patents After State Street Bank

Although the full implications of the language chosen by the court in *State Street Bank* likely was not anticipated, the Patent Office's role is to administer the U.S. patent system in accordance with established laws.¹¹² The

(Oct. 11, 1996); I.R.S. Priv. Ltr. Rul. 9619037 (May 10, 1996).

105. STAFF OF JOINT COMM. ON TAXATION, *supra* note 28, at 14 n.61.

106. *See supra* notes 75-77.

107. CHISUM ET AL., *supra* note 28, at 70.

108. *Bridging the Tax Gap: Hearing Before the S. Comm. on Finance*, 108th Cong. 195 (2004) [hereinafter *Bridging the Tax Gap*] (prepared statement of Nicholas P. Godici, Comm'r for Patents, U.S. Patent and Trademark Office), available at <http://finance.senate.gov/hearings/95484.pdf>.

109. *See infra* Part III.B.

110. Professors Burk and McDonnell argue that the availability of patents “may benefit members of the [tax] profession.” Dan L. Burk & Brett H. McDonnell, *Patents, Tax Shelters, and the Firm*, 26 VA. TAX REV. 981, 983 (2007).

111. *See infra* Part III.B.

112. *Patenting of Tax Advice Hearings*, *supra* note 4, at 7 (statement of James Toupin,

U.S. Constitution, the patent statute, and case law all address the type of subject matter that can qualify for patent protection.¹¹³ While the Patent Office invariably exercises discretion when the law is unclear, the Patent Office has concluded that the Federal Circuit's opinion in *State Street Bank* establishes that tax strategies are patentable if the statutory requirements are satisfied.¹¹⁴

In testifying before a congressional committee in July of 2006, the General Counsel for the U.S. Patent Office stated that the Patent Office "takes its direction on what subject matter is patentable from the Congress and our reviewing courts," and that the Patent Office "is charged with examining patents following certain patentability criteria as enacted by Congress and interpreted by the courts."¹¹⁵ When the Federal Circuit concluded that "Congress is free to declare particular types of inventions unpatentable for a variety of reasons,"¹¹⁶ it stated that the Patent Office cannot declare certain types of inventions unpatentable on public policy or similar grounds.¹¹⁷

Bound by congressional mandate and judicial interpretation, the Patent Office has issued patents on a variety of illegal, and arguably immoral, inventions:¹¹⁸ a method for preparing ricin, useful for toxicological warfare;¹¹⁹

Patent Office General Counsel) ("In administering the U.S. patent laws, the [Patent Office] takes its direction on what subject matter is patentable from Congress and our reviewing courts.").

113. The U.S. Constitution states that Congress shall have the power "[t]o promote the Progress of Science and useful Arts, by securing for limited Times to . . . Inventors the exclusive Right to their . . . Discoveries." U.S. CONST. art. I, § 8, cl. 8. The patent statute describes the subject matter that can be patented as "any new and useful process, machine, manufacture, or composition of matter . . ." 35 U.S.C. § 101 (2000); *see also supra* notes 85-87 and accompanying text. Courts have interpreted the statutory language broadly. *See Diamond v. Chakrabarty*, 447 U.S. 303, 309 (1980) (stating that patentable subject matter should "include anything under the sun that is made by man").

114. As of January 22, 2008, the Patent Office had issued sixty-one tax patents. *See supra* note 28 and accompanying text; *see also Patenting of Tax Advice Hearings, supra* note 4, at 8 (statement of James Toupin, General Counsel, U.S. Patent and Trademark Office).

115. *Patenting of Tax Advice Hearings, supra* note 4, at 7, 9 (statement of James Toupin, General Counsel, U.S. Patent and Trademark Office).

116. *Juicy Whip, Inc. v. Orange Bang, Inc.*, 185 F.3d 1364, 1368 (Fed. Cir. 1999).

117. *Id.*

118. These four patents were listed by James Toupin, Patent Office General Counsel. *Patenting of Tax Advice Hearings, supra* note 4, at 9 (statement of James Toupin, General Counsel, U.S. Patent and Trademark Office).

119. Preparation of Toxic Ricin, U.S. Patent No. 3,060,165 (filed July 3, 1952).

a device for use in cockfights;¹²⁰ a method for producing alcohol during Prohibition;¹²¹ and a radar detector, which is illegal in some jurisdictions.¹²²

In describing the Patent Office's authority, the Patent Office General Counsel stated, "the [Patent Office] 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."¹²³ Since tax strategy patents provide a "useful, concrete and tangible result" as that phrase is used by the Federal Circuit in *State Street Bank*,¹²⁴ the Patent Office must issue patents on tax strategies so long as the other requirements are satisfied.

III. Fundamental Policy Problems with Tax Loophole Patents

The traditional policy rationales for granting patent protection—improving the quality of life for all Americans, strengthening the U.S. economy, and improving the U.S. balance of trade—do not apply to tax loopholes.¹²⁵ "[I]t 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."¹²⁶ Moreover, granting patents on tax loopholes will create multiple problems.

120. Non-lethal Gamecock Sparring Match, Equipment & Methods, U.S. Patent No. 6,928,960 (filed Mar. 5, 2003).

121. Aldehyde-free Alcoholic Liquids, U.S. Patent No. 1,785,447 (filed June 18, 1926).

122. Method and Apparatus for Signal Detection and Jamming, U.S. Patent No. 7,023,374 (filed Oct. 6, 2002).

123. *Patenting of Tax Advice Hearings*, *supra* note 4, at 9 (statement of James Toupin, General Counsel, U.S. Patent and Trademark Office).

124. 149 F.3d 1368, 1373 (Fed. Cir. 1998) (quoting *In re Alappat*, 33 F.3d 1526, 1544 (Fed. Cir. 1994)) (internal quotation marks omitted).

125. See *supra* notes 107-09 and accompanying text.

126. *Patenting of Tax Advice Hearings*, *supra* note 4, at 41 (statement of Ellen Aprill, Professor of Law, Loyola Law Sch. L.A.). The Joint Committee on Taxation has stated,

[S]ome may argue that innovation is either not socially beneficial, or requires no special protection to encourage its undertaking, and thus a fundamental premise behind a patent system is missing. Specifically, many would argue that no social gains from novel tax planning strategies exist as any gain to the user of the strategy is offset by losses to the Treasury, and therefore the resources devoted to producing and using such strategies represent a net loss to society. . . . Others would argue that, regardless of whether tax strategies are socially beneficial, there is no need for patent protection in order to encourage their development as they seem able to proliferate without such protection.

STAFF OF JOINT COMM. ON TAXATION, *supra* note 28, at 25 (footnote omitted).

A. Increasing Complexity of the Tax Code

The complexity of the Internal Revenue Code is legendary. Albert Einstein stated, “[T]he hardest thing in the world to understand is the income tax.”¹²⁷ Many other commentators have eloquently described the situation:

“The Internal Revenue Code is the longest and most complicated statute yet devised by man. . . . [T]he Internal Revenue Code ought to contain a dedication page, reading: This document is a monument to: Taxpayer inventiveness, Judicial intransigence, and Congressional intemperance.”¹²⁸

“The Internal Revenue Code contains . . . a total of more than 1.4 million words—making the tax law four times larger than *War and Peace* and considerably harder to parse. The regulations contain another 8 million words, filling almost 20,000 pages.”¹²⁹

“[Internal Revenue Code] section 341 contains a single sentence that is longer than the entire Gettysburg Address”¹³⁰

“[A] taxpayer filing an individual income tax return (Form 1040) . . . face[s] . . . 144 pages of instructions,” and “the IRS estimates it . . . take[s] . . . 19 hours to complete and file a Form 1040 and the associated Schedule A.”¹³¹

“[The income tax] is way too complicated; estimates suggest ordinary citizens and businesses waste about \$125 billion every year—thirteen cents for every dollar collected—trying to comply with it, or to avoid it.”¹³²

This complexity is fueled by what might be described as the tax loophole cycle—when a new tax law is published, tax advisors pour over the new rules to find advantages for clients who will pay to reduce their taxes;¹³³ if Congress

127. *Murphy v. IRS*, 460 F.3d 79, 92 (D.C. Cir. 2006) (quoting THE MACMILLAN BOOK OF BUSINESS AND ECONOMIC QUOTATIONS 195 (Michael Jackman ed., 1984)) (internal quotation marks omitted), *vacated*, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006), *aff'd*, 493 F.3d 170 (D.C. Cir. 2007), *petition for cert. filed*, 76 U.S.L.W. 3324 (2007).

128. Peter J. Wiedenback, *Charitable Contributions: A Policy Perspective*, 50 MO. L. REV. 85, 86 n.6 (1985).

129. Graetz, *supra* note 14, at 1045; *see also* Jeffrey L. Yablon, *As Certain as Death—Quotations About Taxes*, 110 TAX NOTES 103, 113 (2006) (“Our tax code is so long it makes *War and Peace* seem breezy.”) (quoting Rep. Steven LaTourette).

130. Yablon, *supra* note 129, at 113.

131. Memorandum from J. Russell George, Inspector Gen., Dep’t of the Treasury, to John W. Snow, Secretary, Dep’t of the Treasury 3 (Oct. 27, 2005), *available at* http://www.ustreas.gov/tigta/management/management_fy2006.pdf.

132. Graetz, *supra* note 14, at 1046.

133. *See* Alvin D. Lurie, *How Tax Shelters Evolved: The Road from Crane Has Been Paved with Bad Contentions*, 100 J. TAX’N 274, 275 (2004) (noting that tax advisors have “combed the [Internal Revenue] Code and the judge-made law for crevices, interstices, loopholes, gaps, ambiguities and facial inconsistencies, have extrapolated meaning from particular sections in isolation from other related sections, have honored form over intent, and in other ways have

becomes aware of the loophole and considers it inappropriate, an amendment will be passed to broaden the rules or narrow the exceptions, to close the loophole; tax practitioners then find new loopholes, and the cycle starts over.¹³⁴ As a result, the tax rules become longer and more complex in an attempt to distinguish between deserving and undeserving activities.¹³⁵

The availability of patents will inspire tax practitioners to find and exploit tax loopholes with unprecedented zeal. In the past, a tax inventor could look forward to marketing a tax loophole to her clients, and perhaps consulting with other tax advisors on how to implement the tax strategy. With patents available, the potential payoff from developing a loophole increases exponentially¹³⁶—the patent can allow the inventor to exclude all other tax

claimed to have found the philosopher's stone by which to perform lead-into-gold alchemy”).

134. One reporter describes this process in rather colorful terms. “[The tax planner’s] cat-and-mouse game is to work the loopholes in the system until the government finds them and draws them closed.” David Cay Johnston, *The Loophole Artist*, N.Y. TIMES, Dec. 21, 2003, at SM18. This reporter describes a particular example of this “cat-and-mouse” game as follows:

One of [the loophole artist’s] early insights was that it is entirely and legally possible for the superrich to reap unlimited stock profits without paying a cent of capital gains tax. The rich can do this by manipulating charitable trusts. These trusts are a common enough device used by generous people who own an asset, usually stock, that has appreciated in value. Instead of selling the stock, paying capital gains taxes, and then investing the after-tax proceeds, a person can instead donate the stock to a charitable trust that he controls. The trust can sell the assets tax-free and invest the untaxed proceeds. The income from that investment—typically 6 percent annually—is paid to the donor for life. When the donor dies, what remains in the trust goes to charity.

[The loophole artist] took this clever gimmick and supersized it. He figured out a way to turn that nice little 6 percent annual income stream into a torrent—80 percent returns a year for two years. So on stock gains of \$100 million, the owners would get back at least \$96 million, as opposed to the mere \$72 million they would have gotten if they had sold the stock outright and paid capital gains taxes. Then the trust would fold, and some charity would get the remaining \$4 million. The government would get less than nothing since the gift to the charitable trust would create an income tax deduction.

The technique was so aggressive that when other tax lawyers got their hands on the plan, one of them sent it to the Treasury Department in a plain brown envelope. Treasury responded by instituting new rules, blocking the way to the treasure. But [the loophole artist] quickly chartered another route through those rules, drawing up a new map that allowed billions more dollars to escape capital gains taxes—until the government blocked it, too.

Id. at SM19.

135. *See supra* text accompanying notes 11-12.

136. “[I]f 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

advisors and all other taxpayers from using the loophole for the duration of the patent.¹³⁷ With a patent, all other advisors and taxpayers may become the inventor's clients or licensees. Either way, the patent will translate into higher profits for its holder. This added incentive will inspire tax inventors to find loopholes faster, which will increase the complexity of the U.S. tax laws at an even faster rate.

B. Tax Burdens Shift from the Super-Rich to Other Taxpayers

Patented loopholes will tend to save big dollars for the super-rich. Under existing laws, it will be difficult for Congress to find out about loopholes, and likely impossible for Congress to accurately measure the amount of tax revenue lost from a particular patented loophole.¹³⁸ As a result, Congress will likely increase taxes in all tax brackets, which would shift tax burdens from the super-rich to all other taxpayers.

Tax inventors will tend to develop tax-saving strategies for the super-rich because the super-rich have the most to gain from these strategies and can afford to pay high royalties. A large portion of the patents issued, and the patent applications that have been filed and made public through January 22, 2008, concern estate tax,¹³⁹ investments,¹⁴⁰ retirement planning,¹⁴¹ and

to pay a royalty to gain this advantage." *Patenting of Tax Advice Hearings*, *supra* note 4, at 35 (statement of Richard S. Gruner, Professor of Law, Whittier Law Sch.).

137. See 35 U.S.C. § 271(a) (2000). The inventor can license the loophole to potential users and collect royalty income to profit from the loophole.

138. This Article argues that taxpayers should be required to provide detailed information when they use patented tax strategies. See *infra* Part V.C. This will allow the U.S. government to know how much tax revenue is lost because of each patented tax strategy. With this information, hopefully Congress can specifically tailor rules that eliminate the loophole, and as a result, Congress will refrain from raising taxes for other taxpayers.

139. See *Establishing and Managing Grantor Retained Annuity Trusts Funded by Nonqualified Stock Options*, U.S. Patent No. 6,567,790 (filed Dec. 1, 1999); *Method and Apparatus that Processes Financial Data Relating to Wealth Accumulation Plans*, U.S. Patent No. 5,991,744 (filed Oct. 31, 1997). Additionally, at least five patent applications involve estate tax planning. See *Apparatus and Method for Implementing and/or Administering a Wealth Transfer Plan*, U.S. Patent Application No. 20,030,105,701 (filed Apr. 18, 2002); *Method and Apparatus for Establishing and Administering a Wealth Transfer Plan*, U.S. Patent Application No. 20,030,105,700 (filed Jan. 9, 2002); *Method and Apparatus for Transferring Wealth*, U.S. Patent Application No. 20,030,105,691 (filed Jan. 9, 2002); *Wealth Transfer Plan Using in Kind Loan Repayment with Term Insurance Protection*, U.S. Patent Application No. 20,030,130,939 (filed Jan. 9, 2002); *Wealth Transfer Plan Using in Kind Loan Repayment with Term Insurance Protection for Return of Note*, U.S. Patent Application No. 20,030,130,935 (filed Jan. 9, 2002).

140. The titles of several issued patents involve investment planning. See *Method and Apparatus for Tax Efficient Investment Management*, U.S. Patent No. 7,031,937 (filed Jan. 18, 2002); *Method, System, and Apparatus for Managing Taxable Events Within a Portfolio*, U.S. Patent No. 6,516,303 (filed Oct. 17, 2000); *System for and Method of Variable Annuity*

charitable giving¹⁴²—topics that are especially important to the super-rich. For example, the estate tax only applies if the decedent had substantial wealth—over \$2 million for decedents dying in 2008, and \$3.5 million for decedents dying in 2009.¹⁴³

When Congress considers a tax statute, the congressional Joint Committee on Taxation estimates the amount of tax revenue that will be raised.¹⁴⁴ These estimates are used to predict whether the government will have sufficient funds to meet its obligations. If unexpected tax loopholes cause actual tax revenue collected to fall short of the target, the government will need to raise additional

Contract Administration, U.S. Patent No. 7,016,871 (filed July 25, 2000); Method and Apparatus for Tax-Efficient Investment Using Both Long and Short Positions, U.S. Patent No. 6,832,209 (filed Oct. 6, 1999); Method and Apparatus for Tax Efficient Investment Mangement, U.S. Patent No. 6,687,681 (filed May 28, 1999).

141. The titles of patents and patent applications involving retirement plans include: System and Method for Creating a Defined Benefit Pension Plan Funded with a Variable Life Insurance Policy and/or a Variable Annuity Policy, U.S. Patent No. 6,963,852 (filed Feb. 28, 2002); Method for Hedging One or More Liabilities Associated with a Deferred Compensation Plan, U.S. Patent No. 6,766,303 (filed Oct. 15, 2001); Method and Apparatus for Modeling and Executing Deferred Award Instrument Plan, U.S. Patent No. 6,609,111 (filed Oct. 18, 2000); System and Method for Creating a Retirement Plan Funded with a Variable Life Insurance Policy and/or a Variable Annuity Policy, U.S. Patent Application No. 20,060,080,148 (filed Oct. 21, 2005); Method and System for Administering the Hedging of an Employee Deferred Compensation Plan Using Swaps, U.S. Patent Application No. 20,050,131,798 (filed Jan. 6, 2004); Method and System for Managing a Non-Qualified Deferred Compensation Program Using Hedging, U.S. Patent Application No. 20,040,230,505 (filed May 14, 2003).

142. The titles of five patent applications involve charitable planning: System and Method for Administering Charitable Funds Through Affiliations of Professionals, U.S. Patent Application No. 20,050,256,791 (filed May 14, 2004); Method and System of Charitable Fundraising and Socially Responsible Investment Involving Life Insurance Products, U.S. Patent Application No. 20,040,181,436 (filed Oct. 22, 2003); Financing the Donation of Life Insurance Proceeds, U.S. Patent Application No. 20,040,199,446 (filed Mar. 14, 2003); Method and System for Generating Endowment for a Tax-Exempt Organization, U.S. Patent Application No. 20,040,019,506 (filed July 23, 2002); Method and Apparatus for Establishing and Administering a Charitable Gift Transfer Plan, U.S. Patent Application No. 20,030,105,690 (filed Jan. 9, 2002).

143. I.R.C. § 2010(c) (Supp. IV 2004); *see also supra* note 10 and accompanying text.

144. The Joint Committee on Taxation was statutorily assigned the duty of projecting revenue estimates.

Under the Congressional Budget Act of 1974, the Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) are to provide estimates of the budgetary effects of all legislative proposals reported by Congressional committees. The Act assigns JCT the responsibility of preparing the estimates of most revenue legislation, and CBO does the estimates of spending proposals.

Assessing the Accuracy of Federal Budget Estimating: Hearing Before the Subcomm. on Legis. & Budget Process of the H. Comm. on Rules, 107th Cong. (2002) (hearing background), available at http://www.rules.house.gov/archives/rules_hear15estimating.htm.

taxes.¹⁴⁵ The U.S. Supreme Court, in discussing the use of a tax saving technique by wealthy individuals has stated, “when an individual in a high income tax bracket” reduces his tax liability, it is “at the expense, ultimately, of all other taxpayers and the Government.”¹⁴⁶

Patented tax loopholes will result in tax revenue shortfalls, and because those loopholes are not obvious,¹⁴⁷ they will surprise the government.¹⁴⁸ If Congress eventually learns about the loophole, it can attempt to close it. However, if Congress is unaware of the loophole, or the magnitude of the tax revenue lost because of the loophole, or simply chooses not to close the loophole in the absence of detailed information, Congress may enact broad, sweeping changes that raise more taxes from all taxpayers. Congress may increase tax rates across the board.¹⁴⁹ Even when Congress reduces tax rates, it may eliminate exclusions and deductions which can effectively increase the tax burden for less wealthy taxpayers. For example, in the mid-1980’s, Congress reduced tax rates, but substantially broadened the tax base, eliminating exclusions and deductions for certain taxpayers.¹⁵⁰ Thus, tax burdens can shift from the super-rich to all other tax payers.

145. See Johnston, *supra* note 134, at SM18 (“[The loophole artist] helps the superrich keep their riches—at the expense of everyone else.”). Politicians have even written poems about the fact that if taxes decrease for one group, they must rise for another.

Don’t tax you, don’t tax me;
Tax the fellow behind the tree.

Yablon, *supra* note 129, at 113 (quoting Sen. Russell B. Long).

Don’t tax you. Don’t tax me.
Tax the companies across the sea.

Id. (quoting Rep. Dan Rostenkowski).

146. *Dickman v. Comm’r*, 465 U.S. 330, 339 (1984) (discussing the use of substantial interest-free loans to family members).

147. 35 U.S.C. § 103(a) (2000); see also *supra* note 96 and accompanying text.

148. See *supra* notes 96-102 and accompanying text.

149. “The story is always the same [in Congress]: Higher rates are imposed and at the same time loopholes are carefully framed which permit the wealthy to get out from under the higher taxes.” Yablon, *supra* note 129, at 113 (alteration in original) (quoting Vice President Hubert H. Humphrey).

150. For example, the Tax Reform Act of 1986 was praised for closing loopholes and reducing tax rates, but it repealed the tax deduction for “personal interest” paid. See I.R.C. § 163(h) (2000); 2 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 31.1 (3d ed. 2000). “Personal interest” includes consumer interest, *id.*, such as interest paid on credit card debt, interest paid on a debt to purchase consumer appliances such as a washer, dryer, or refrigerator, and interest paid on a loan to purchase a car for personal use. Since the wealthy do not need to borrow to make their personal purchases, the repeal of the personal interest deduction effectively increased taxes for those who need to borrow to make consumer purchases.

C. Taxpayer Morale Will Drop, Further Jeopardizing the Voluntary Compliance Tax System

Tax loophole patents will increase the complexity of the tax laws,¹⁵¹ and “[t]he complexity of the tax law is . . . a significant factor in causing the tax gap.”¹⁵² The tax gap measures the difference between the taxes that should be paid, and the taxes that are paid.¹⁵³ As the complexity of the tax system has increased, the tax gap has grown.

Amount of the Tax Gap¹⁵⁴

Tax Year	Tax Gap	in 2001 Dollars
1973	\$29 billion	\$115.6 billion
1981	\$87 billion	\$169.4 billion
2001	\$312 billion	\$312 billion

Related statistics indicate that U.S. taxpayers only pay approximately 85% of the taxes they owe.¹⁵⁵ While employees typically report all their income to the IRS, and pay the full amount of tax owed,¹⁵⁶ self-employed individuals and those who can engage in financial transactions that are not automatically reported to the IRS (on Form W-2, Form 1099, or otherwise), have opportunities to under-report their taxable income. Approximately 85% of the tax gap is attributable to under-reported income.¹⁵⁷ “[S]elf-employed individuals who . . . operate non-farm

151. *See supra* notes 133-37 and accompanying text.

152. I.R.S. News Release IR-2006-28 (Feb. 14, 2006), available at <http://www.irs.gov/pub/irs-news/ir-06-028.pdf>.

153. *See supra* notes 20-21 and accompanying text.

154. *The \$350 Billion Question: How to Solve the Tax Gap: Hearing Before the S. Comm. on Finance*, 109th Cong. 281 (2005) [hereinafter *Solving the Tax Gap Hearing*] (prepared statement of J. Russell George, Inspector General for Tax Administration, Dep’t of the Treasury), available at <http://finance.senate.gov/hearings/26535.pdf>. Even after the IRS completes its audits (and collects taxes from those audits) for the 2001 tax year, the gap for that year is still estimated to be approximately \$290 billion. *See* I.R.S. News Release, *supra* note 152.

155. I.R.S. Fact Sheet, *supra* note 20 (“For Tax Year 2001, all taxpayers paid \$1.767 trillion on time, a figure that represents from 83.4 percent to 85 percent of the total amount due.”).

156. These taxpayers do not have the same opportunity to commit tax fraud as others, because their income amounts are automatically reported to the IRS on Form W-2 (or other information reporting forms). *See generally* I.R.C. § 3401 (2005). Chapter 24 of Subtitle C of the Internal Revenue Code is titled “Collection of Income Tax at Source on Wages”. *Id.*

157. *Solving the Tax Gap Hearing*, *supra* note 154, at 284 (prepared statement of J. Russell

businesses are estimated to report only about 68 percent of their income for tax purposes,”¹⁵⁸ and “self-employed individuals operating businesses on a cash basis report just 19 percent of their income to the IRS.”¹⁵⁹ The cash economy is growing and constitutes approximately 9% of the U.S. gross domestic product.¹⁶⁰

These statistics are disturbing. All U.S. citizens and residents with sufficient gross income are required to file a tax return and pay income tax.¹⁶¹ However, when income is not subject to information reporting or withholding, the U.S. tax system depends on the taxpayer voluntarily filing a tax return and reporting the amounts.¹⁶² The IRS only audits approximately 2.13% of self-employed individuals.¹⁶³

Two closely-linked factors that can greatly diminish voluntary compliance are (i) complexity and (ii) perceived unfairness.

The more complex the tax system is, the harder it is to fathom its outcomes. Moreover, different taxpayers have different abilities to manipulate a complex system. There is substantial—and well-founded—public suspicion that well-heeled . . . taxpayers can use a complex system to their advantage, while other taxpayers cannot. Such a suspicion can seriously erode voluntary compliance, which is the bedrock of our system.¹⁶⁴

George, Inspector General for Tax Administration, Dep’t of the Treasury) (“The largest estimated component of the tax gap is the underreporting component, which for [fiscal year] 2001 was . . . between \$250 and \$292 billion.”). See I.R.S. News Release, *supra* note 152.

158. *Id.*

159. *Id.*

160. *Id.*

161. I.R.C. § 6012(a)(1)(A) (“Returns with respect to income taxes . . . shall be made by . . . [e]very individual having for the taxable year gross income which equals or exceeds the exemption amount . . .”).

162. See *United States v. Schiff*, 876 F.2d 272, 275 (2d Cir. 1989) (“To the extent that income taxes are said to be ‘voluntary,’ [] they are only voluntary in that one files the returns The payment of income taxes is not optional . . .”).

163. See *Solving the Tax Gap Hearing*, *supra* note 154, at 287 (prepared statement of J. Russell George, Inspector General for Tax Administration, Dep’t of the Treasury).

Taxes will never be rip-roaringly popular Still, it is important that there be broad public support for the system. In the United States, . . . taxpayers make the first determination of their liabilities through the returns they prepare and file. Moreover, with the low IRS audit coverage that currently prevails, that first determination usually is the last determination. [As a result,] it is important that taxpayers have sufficient commitment to the system [so] that their returns bear reasonable relation to reality.

Steven R. Johnson, *Administrability-Based Tax Simplification*, 4 NEV. L.J. 573, 581 (2004) (footnote omitted).

164. Johnson, *supra* note 163, at 580 (footnote omitted). Another commentator echoes this

The Chief of Staff of the Joint Committee on Taxation has stated, “[T]oday’s tax complexity [] clearly decreases levels of voluntary compliance”¹⁶⁵ The IRS Taxpayer Advocate has stated “The most serious problem facing taxpayers and the IRS alike is the complexity of the Internal Revenue Code.”¹⁶⁶ “A [] complex system that alienates taxpayers undercuts the base of support crucial to the enterprise of American taxation.”¹⁶⁷

Taxpayers can “under-report” their income in many different ways—through off-shore tax gimmicks;¹⁶⁸ failing to report cash received (through the use of the “shadow economy”¹⁶⁹ or otherwise); or participating in much more complicated illegal tax schemes.¹⁷⁰ Some taxpayers simply drop out completely.

The actor Wesley Snipes¹⁷¹ reportedly “failed to file [income] tax returns

view.

Complex laws spawn . . . opportunities for intentional noncompliance. Complex laws also contribute to taxpayer confusion and real or perceived unfairness in the tax system. Studies have shown that taxpayers are less likely to be compliant if they perceive the tax system to be inequitable.

Solving the Tax Gap Hearing, *supra* note 154, at 398 (prepared statement of George K. Yin, Chief of Staff, Joint Comm. on Taxation).

165. Patti Mohr, *Specialists Discuss Simplification in Light of Bush’s Tax Plan*, 91 TAX NOTES 867, 868 (2001) (quoting Lindy L. Paull, Former Chief of Staff, Joint Comm. on Taxation).

166. NINA E. OLSON, TAXPAYER ADVOCATE SERVICE OF THE IRS, 2004 ANNUAL REPORT TO CONGRESS 2 (2004), available at <http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf>.

167. Johnson, *supra* note 163, at 581.

168. *See supra* notes 16-19.

169. *See Black Market/Shadow Economy*, 1 ENCYCLOPEDIA OF THE DEVELOPING WORLD 180 (Thomas M. Leonard ed., 2006) (“The shadow economy can be defined as the economy that comprises all economic activities where goods and services are produced but not reported. It therefore includes illicit and criminal activities, as well as all unreported income from the production of legal goods and services In other words, the shadow economy refers to all economic activities that take place outside the official economy and that would be taxable if reported to the tax authorities.”). Other commentators have stated,

The American people as taxpayers have begun in wholesale numbers to cheat, out of resentment of a tax system they think is unfair, too complicated and wasteful of their money. The so-called underground economy is growing rapidly—people working for cash only, reporting nothing, paying nothing.

Yablon, *supra* note 129, at 154 (quoting David Brinkley, News Anchor, National Broad. Corp. (NBC)).

170. *See Solving the Tax Gap Hearing*, *supra* note 154, at 290 (prepared statement of J. Russell George, Inspector General for Tax Administration, Dep’t of the Treasury) (“At the other end of the economic spectrum, white collar professionals and executives have used the complexities of the tax code to devise intricate schemes to *illegally* shelter income from taxation.” (emphasis added)).

171. Wesley Snipes was the star of the *Blade* trilogy of films. David Cay Johnston, *Wesley Snipes Is Charged with Tax Fraud*, N.Y. TIMES, Oct. 18, 2006, at E3. [hereinafter Johnston,

from 1999 to 2004, and falsely claimed almost \$12 million in refunds for 1996 and 1997.”¹⁷² It was reported that Mr. Snipes’ income for 1997 was over \$19 million.¹⁷³ It was also alleged that Mr. Snipes “submit[ed] \$13 million in fake checks to pay his taxes.”¹⁷⁴ The U.S. Justice Department alleges that Mr. Snipes is just one of approximately 152,000 people who tried to evade paying “tens of millions of dollars in taxes” under this and similar schemes.¹⁷⁵ The government contends that people using the same scheme as Mr. Snipes have filed “[n]early 2,000 bogus misconduct complaints against Internal Revenue Service agents”¹⁷⁶

This story vividly demonstrates the importance of voluntary compliance for the U.S. tax system, as the government has great difficulty in combating these schemes. “So far [only] eight people taking this position have been convicted.”¹⁷⁷

While Mr. Snipes’s attempt to have his taxes refunded failed, thousands of other people received refunds. The lawsuit [filed by the Justice Department in 2003] says the I.R.S. has not recovered most of those refunds and will probably not do so. People

Wesley Snipes Tax Fraud].

172. David Cay Johnston, *Actor Pleads Not Guilty in Tax Fraud Case*, N.Y. TIMES, Dec. 9, 2006, at A13. “Variety, the Hollywood trade publication, reported . . . that ‘Snipes will not be jailed’ . . . [and has] agreed to an installment plan to pay about \$13 million in taxes” David Cay Johnston, *No Deal Made with Actor in Tax Case, Prosecutors Say*, N.Y. TIMES, Nov. 7, 2006, at C2.

173. David Cay Johnston, *Court Is Asked to Block False Complaints Against I.R.S.*, N.Y. TIMES, Dec. 9, 2003, at C4. [hereinafter Johnston, *False Complaints*].

174. Johnston, *Wesley Snipes Tax Fraud*, *supra* note 171, at E3; *see also* David Cay Johnston, *U.S. Discloses That Use of Tax Evasion Plans Is Extensive*, N.Y. TIMES, May 22, 2002, at C4. [hereinafter Johnston, *Tax Evasion Plans Extensive*].

175. Johnston, *Wesley Snipes Tax Fraud*, *supra* note 171, at E3. This scheme was “known as the 861 position.” *Id.*

Two Florida men were indicted with [Wesley Snipes]: Eddie Ray Kahn, founder of American Rights Litigators and its successor, Guiding Light of God Ministries; and Douglas P. Rosile Sr., a former accountant. They are leaders in a movement that contends that most Americans are not required to pay income tax, an argument the courts have repeatedly rejected as frivolous.

Id.

176. Johnston, *False Complaints*, *supra* note 173, at C4. Wesley Snipes’ tax fraud trial began January 14, 2008. Travis Reed, *Actor Snipes Heads to Trial Today on Tax Fraud, Conspiracy Charges*, S. FLA. SUN SENTINEL, Jan. 14, 2008, at 12B, available at Westlaw, 2008 WLNR 745128.

177. Johnston, *Wesley Snipes Tax Fraud*, *supra* note 171, at E3.

connected to [the scheme] have used such refund checks to persuade others that there is a legal way to escape taxes.¹⁷⁸

In addition, the IRS “revealed that it had identified 1,500 businesses that had stopped withholding taxes from their employees’ paychecks or filed corporate tax returns showing zero income. The I.R.S. suggested that more businesses escape detection by simply not filing a return.”¹⁷⁹ “Among the claims made are that income taxes are voluntary, that no definition of income exists so anyone can report zero income, [and] that only foreign-owned corporations are taxable People who sell or promote such practices have flourished Promoters have sold their products to many wealthy Americans”¹⁸⁰ The government’s difficulty in collecting the amount of tax due in these situations highlights the importance of voluntary compliance in the U.S. tax system.

[C]ourt papers show that some of these promoters have become so bold that they remain in business even after the Justice Department has sued them. Boasting of their success in their brochures, in lectures and on the Internet, they continue[] helping clients file false returns.

. . . .

Promoters use lectures, radio shows, newsletters and the Internet to promote a variety of tax-avoidance strategies based on theories that have all been rejected in court.

Rae Ann Thurell, an I.R.S. manager who works with what the [IRS] calls frivolous returns, said that dealing with bogus returns . . . “places a severe administrative burden on the I.R.S.”

Just reading such returns and sending a notice that they are being disregarded takes an average of 2.5 hours each. For 152,000 frivolous returns that would be 1.4 percent of all the time the I.R.S. has to audit 200 million tax returns.

Ms. Thurell gave no estimate of how much time it would take to pursue the average tax protester who does not cooperate nor how much it costs when individuals just ignore the notices and stop filing, as many promoters of tax evasion practices recommend clients do.¹⁸¹

178. Johnston, *False Complaints*, *supra* note 173, at C4.

179. Johnston, *Tax Evasion Plans Extensive*, *supra* note 174, at C4.

180. *Id.*

181. *Id.*

Tax patents will increase the complexity of the U.S. tax system by accelerating the tax loophole cycle. In addition to the complexity, tax patents will increase taxpayer frustration as taxpayers will be forced to choose between paying license fees or paying extra taxes, and in some situations may be forced to pay license fees even though they do not copy or benefit in any other way from the patent-holder's tax invention.¹⁸² Greater complexity and frustration will undermine voluntary compliance and drive more taxpayers into illegal tax gimmicks and may inspire some taxpayers to "drop out" of the tax system completely. This will increase taxes and complexity for those taxpayers who try to satisfy their legal tax obligations.

D. Disparate Treatment of Similarly-Situated Taxpayers and Related Issues

A fundamental tax principle—"horizontal equity"—is that similarly situated taxpayers should be taxed the same.¹⁸³ But commentators have noted that tax strategy patents would disrupt horizontal equity in at least four different ways.¹⁸⁴ As a result, similarly situated taxpayers will be treated differently.

182. While 35 U.S.C. § 273 grants a "first to invent" defense for business method patents, the person raising the defense must show that she "act[ed] in good faith, actually reduced the subject matter to practice at least 1 year before the effective filing date of such patent, and commercially used the subject matter before the effective filing date of such patent." 35 U.S.C. § 273(b)(1) (2000).

183. JOEL S. NEWMAN, FEDERAL INCOME TAXATION: CASES, PROBLEMS, AND MATERIALS 25 (3d ed. 2005).

184. First, "tax strategy patents [might] encumber the ability of taxpayers and their advisors to use the tax law freely . . ." STAFF OF JOINT COMM. ON TAXATION, *supra* note 28, at 4. Second, "an individual has been allowed to privatize a tax reduction technique authorized by the United States government." *Patenting of Tax Advice Hearings, supra* note 4, at 46 (statement of Dennis I. Belcher, Partner, McGuireWoods LLP). Mr. Belcher provided the following example:

Consider the result if an individual had patented the transfer of appreciated securities to a charitable remainder trust . . . when Congress first allowed these types of trusts in 1969. 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.

Id. at 47. Third, "patent-holders [will] 'capture' a property right in the Internal Revenue Code itself . . . and extract economic rent from other tax practitioners (and taxpayers) . . ." STAFF OF JOINT COMM. ON TAXATION, *supra* note 28, at 21. And finally,

[t]hese patents [] have the potential to unfairly skew the marketplace. Imagine that a single company in a competitive industry devises a highly effective tax strategy. . . .

. . . . If the . . . company patents its tax strategy [then that] company can refuse to license the patent to its competitors. For the 20-year life of that patent, the

Specifically, the inventor can use the patented loophole without paying a royalty and pay less taxes. Other taxpayers would be forced to pay royalties to use the tax loophole (as long as the royalties and other transaction costs do not exceed the potential savings). Still other taxpayers will not use the loophole and will pay higher taxes, either because they had no opportunity to license the loophole, or because they believed that the royalties and the transaction costs exceeded the taxes payable. For example, some taxpayers may believe that using the loophole will cause them to be audited by the IRS.¹⁸⁵

While patented tax loopholes cause horizontal inequity, this argument may not stir policy-makers to action. As discussed above, big financial service firms, law firms, CPA firms, and other tax inventors are most likely to develop tax loopholes for the super-rich.¹⁸⁶ When the availability of patent protection creates a tax loophole for the super-rich, the argument would be that some super-rich people (or entities) are being taxed unfairly because they cannot use the loophole without paying a royalty. It is difficult to generate sympathy among the general population for a super-rich individual, corporation or estate by arguing that the super-rich individual, corporation or estate has to pay some extra tax.

For example, the one patented tax strategy that has been subject to litigation—the SOGRAT¹⁸⁷—can save estate taxes for individuals with

company can realize a substantial advantage from simultaneously using the tax strategy itself and placing it off-limits to others.

This economic advantage flows not from providing better goods and services . . . but from developing a better way to secure tax benefits from the government.

Paul Devinsky et al., *Whose Tax Law Is It?*, LEGAL TIMES (IP SUPP.), Oct. 16, 2006, available at <http://www.mwe.com/info/pubs/legaltimes101806.pdf>.

185. One commentator described the situation for the taxpayer who does not acquire a license from the patent-holder as follows:

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.

Patenting of Tax Advice Hearings, *supra* note 4, at 47 (statement of Dennis I. Belcher, Partner, McGuireWoods LLP).

186. See *supra* Part III.B.

187. Establishing and Managing Grantor Retained Annuity Trusts Funded by Nonqualified Stock Options, U.S. Patent No. 6,567,790 (issued May 20, 2003). On Jan. 6, 2006, Wealth Transfer Group filed a complaint in a federal district court in Connecticut against John W. Rowe, alleging that he infringed its SOGRAT patent, and seeking an injunction and damages.

substantial amounts of wealth in stock options. For decedents dying in 2008, the estate tax only applies if the individual has a gross estate in excess of \$2 million, and for decedents dying in 2009, the estate tax will only apply if the decedent has a gross estate in excess of \$3.5 million.¹⁸⁸ The fact that some corporate executives with millions of dollars may pay more in estate taxes than other corporate executives with millions may not be considered a serious crisis.¹⁸⁹

IV. Congress Is Unlikely to Prohibit Tax Loophole Patents

While the case for prohibiting patents on tax loopholes is strong, structural considerations that involve the entire U.S. patent system likely will prevent Congress from amending the patent statutes to prohibit tax loophole patents.¹⁹⁰ This congressional inertia can be attributed to three distinct factors: (1) Congress is under constant pressure to maintain a “technology-neutral” patent

Wealth Transfer Group v. Rowe, No. 3:06CV00024(AWT) (D. Conn. Mar. 9, 2007); *see also* Steven Seidenberg, *Crisis Pending*, ABA J., May 2007, at 42, 44, available at http://www.abajournal.com/magazine/crisis_pending. The case settled March 9, 2007, and the parties stipulated that the SOGRAT patent is presumed to be valid, “that there are facts from which a trier of fact could conclude that the [SOGRAT] Patent is not invalid and is not unenforceable,” and “[b]ased upon the parties stipulations, the court decreed that the SOGRAT patent ‘is adjudged to be valid and enforceable.’” Richard S. Marshall, *Tax Strategy Patents—Legislative, Judicial and Other Developments 2-3* (2007), available at <http://www.abanet.org/tax/patents/articles/taxstrategypatents.pdf>.

188. I.R.C. § 2010(a) (2000).

189. There are also several other arguments that have been previously made against issuing tax strategy patents. First, patents might issue on inventions that do not meet the statutory requirements. *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 28, at 3. Second, “tax strategy patents [might] lead to the marketing of aggressive tax shelters” *Id.* at 4. Third, taxpayers and their advisors will need to perform patent searches in connection with tax planning. *Id.*; *Patenting of Tax Advice Hearings*, *supra* note 4, at 41 (statement of Ellen Aprill, Professor of Law, Loyola Law Sch. L.A.) (“[T]axpayers, their advisors, 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.”); *see also id.* at 13 (statement of Mark Everson, Comm’r, Internal Revenue Service) (“[P]atented tax strategies place an increased burden on practitioners”). Finally, an inventor might patent the only “manner of complying with the requirements of the Internal Revenue Code and administrative guidance thereunder.” STAFF OF JOINT COMM. ON TAXATION, *supra* note 28, at 25.

190. “Death and taxes are inevitable.” Yablon, *supra* note 129, at 103 (quoting Thomas Chandler Haliburton, Author). But, the tax laws often change. *See also id.* (“[T]here’s one advantage about death: it doesn’t get worse every time Congress meets.” (quoting Erwin N. Griswold, U.S. Solicitor General)). While bills are pending to prohibit tax-strategy patents, *see supra* note 23 and accompanying text, several structural reasons likely will prevent their passage. *See infra* Part IV.

system; (2) broader patent reform efforts; and (3) international patent law considerations.

A. The Pressure to Keep the U.S. Patent System “Technology-Neutral”

A frequent battle-cry of those who desire to expand the range of patentable subject matter is that the U.S. patent system should remain technology-neutral, such that it applies equally to all different types of inventions, regardless of the field of endeavor involved.¹⁹¹ Any suggestion that Congress should prohibit tax strategy patents could be attacked on these grounds because it would carve out an exception for inventions in one particular field. Patent practitioners argue with tremendous zeal for the preservation of a uniform patent system.

The patent system is not designed to assure that the benefits associated with the issuance of every patent outweigh the costs of the individual patent. The patent system is not even designed to assure that the benefits of every patent class outweigh the costs of issuing the patents in that class. The societal cost of some patents surely will outweigh the societal benefit of the patent. . . . The patent system is designed such that the benefits of issued patents, as a whole, outweigh the costs of the issued patents, as a whole. It may be possible to surgically excise patents, or patent classes, that do not provide a net benefit to society, but attempts to perform this surgery are fraught with dangers that threaten the entire patent system.¹⁹²

The Federal Circuit has described the Patent Act as technology-neutral,¹⁹³ and the Patent Commissioner has emphasized that there must be “no disparate treatment of different categories of invention.”¹⁹⁴ It may be argued that these

191. “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.” *Patenting of Tax Advice Hearings*, *supra* note 4, at 7 (statement of James Toupin, General Counsel, U.S. Patent and Trademark Office) (emphasis added). “[T]he patent system is technology neutral and there shall be no disparate treatment for different categories of inventions.” *Bridging the Tax Gap*, *supra* note 108, at 197 (statement of Nicholas P. Godici, Comm’r for Patents, U.S. Patent and Trademark Office); *see also infra* notes 193-94 and accompanying text.

192. Jeffrey R. Kuester & Lawrence E. Thompson, *Risks Associated with Restricting Business Method and E-Commerce Patents*, 17 GA. ST. U. L. REV. 657, 673 (2001).

193. *Moba, B.V. v. Diamond Automation, Inc.*, 325 F.3d 1306, 1325-26 (Fed. Cir. 2003).

194. *Bridging the Tax Gap*, *supra* note 108, at 197 (statement of Nicholas P. Godici, Comm’r for Patents, U.S. Patent and Trademark Office). The Patent Office Commissioner also stated, “[A]ny arbitrary restriction of patentability in this or other technologies would certainly have negative consequences for our country including causing deserving innovations to go unprotected and causing deserving investments to go unrewarded.” *Id.*

statements are consistent with the view that the range of patentable subject matter should be expanded, which will increase the importance of the Federal Circuit,¹⁹⁵ the Patent Office, and patent practitioners.

Nevertheless, the terms of the patent statute are remarkably uniform.¹⁹⁶ The statutory rules for determining patentability and infringement apply equally to inventions in all fields of endeavor, except for six specific exceptions.¹⁹⁷ “[I]t is an undifferentiated, one-size-fits-all system.”¹⁹⁸ While commentators argue that courts “apply” the statutory rules differently depending on the industry involved,¹⁹⁹ the terms of the statutory rules tend to be uniform.

Professors Burk and Lemley list several potential problems if every industry successfully lobbies Congress to adopt patent statutes that fit the particular needs of the industry:

(1) The patent statutes would become incredibly complex, and could even approach the complexity of the Internal Revenue Code.²⁰⁰

195. See *supra* notes 53-56 and accompanying text.

196. “Despite periodic revisions, most recently in 1952, the basic structure of the patent system has remained unchanged for 165 years.” Dan L. Burk & Mark A. Lemley, *Is Patent Law Technology Specific?*, 17 BERKELEY TECH. L.J. 1155, 1159 (2002) [hereinafter Burk & Lemley, *Technology Specific*].

197. First, Congress prohibits the patenting of “any invention or discovery which is useful solely in the utilization of special nuclear material or atomic energy in an atomic weapon.” 42 U.S.C. § 2181(a) (2000). Second, a patent on a medical procedure cannot be enforced against a health care provider. 35 U.S.C. § 287(c) (2000). Third, pharmaceutical patents can have a longer term than patents on other inventions. See Dan L. Burk & Mark A. Lemley, *Policy Levers in Patent Law*, 89 VA. L. REV. 1575, 1631 n.178 (2003) [hereinafter Burk & Lemley, *Policy Levers*] (citing 35 U.S.C. §§ 155-156). Fourth, the rules on infringement exclude certain “experimental uses” by suppliers of generic pharmaceuticals. See *id.* at 1631 n.179 (citing 35 U.S.C. § 271(e)). Fifth, special rules apply when determining if biotechnology processes meet the “obvious” standard. See *id.* at 1631 n.181 (citing 35 U.S.C. § 103(b)). Sixth, certain prior uses will not be deemed to infringe a business method patent. See *id.* at 1631 n.182 (citing 35 U.S.C. § 273(a)(3)). All six of these exceptions are discussed in greater detail by Professors Dan L. Burk and Mark A. Lemley. See *id.* at 1631.

198. Burk & Lemley, *Technology Specific*, *supra* note 196, at 1155.

199. “[I]t appears that while patent law is technology-neutral in theory, it is technology-specific in application.” Burk & Lemley, *Technology Specific*, *supra* note 196, at 1156. “Despite the appearance of uniformity, patent law is actually as varied as the industries it seeks to foster.” Burk & Lemley, *Policy Levers*, *supra* note 197, at 1577; see also *id.* at 1576.

200. Burk & Lemley, *Technology Specific*, *supra* note 196, at 1637-38 (“The copyright model—in which industry-specific rules and exceptions have led to a bloated, impenetrable statute that reads like the tax code—is hardly one patent law should emulate.” (footnote omitted)). Professors Burk and Lemley state that separate patent rules would be needed for biotechnology, software, semiconductors, pharmaceuticals, chemicals, nanotechnology, and telecommunications. *Id.* at 1635. The complexity of the tax system frequently inspires criticism. See *supra* notes 127-32.

(2) Along with complexity comes administrative costs, which would include all the costs involved in educating Congress about the patent rules needed for each particular industry;²⁰¹ costs for the Patent Office, practitioners, and the courts to understand and interpret all the different statutes; and all the costs that accompany uncertainty.²⁰²

(3) The statutes enacted may not further the policy goals of the patent system—to promote technological advances.²⁰³

(4) Innovations could be difficult to categorize, as inventions often involve elements of more than one industry.²⁰⁴

(5) The prospect of obtaining favorable patent legislation could lead to inefficient lobbying battles as the inventors and users in a particular industry each try to persuade Congress to enact patent rules favorable to their side.²⁰⁵ Although pointing out that the patent system uses “a monolithic legal incentive for wildly disparate industries,”²⁰⁶ Professors Burk and Lemley conclude that “We should not jettison our nominally uniform patent system in favor of specific statutes that protect particular industries.”²⁰⁷

Another potential problem is the impact that more complex patent statutes could have on potential investors and promoters of new inventions. While the patent system certainly encourages inventors, it also serves to encourage investors.²⁰⁸ As discussed above, the patent monopoly allows an inventor to charge a monopoly price,²⁰⁹ but often an inventor does not want to engage in all the activities necessary to sell a product based on a patented process. For

201. See Burk & Lemley, *Technology Specific*, *supra* note 196, at 1158 (“As a practical matter, Congress cannot enact a new form of intellectual property statute each time a new technology arises.”).

202. See Burk & Lemley, *Policy Levers*, *supra* note 197, at 1635 (“The resulting uncertainty would perhaps enrich lawyers, but it surely would not be conducive to encouraging innovation.”).

203. See *id.* at 1634 (“[We] are skeptical of the ability of a statute to dictate in detail the right patent rules for each industry.”).

204. See *id.* at 1635-36 (“There would also be a great deal of line drawing to be done, as the boundaries between industries are vague and notoriously mutable. . . . [N]ew fields [would] arise regularly; imagine trying to fit all modern inventions into categories created fifty or one hundred years ago.”).

205. *Id.* at 1637-38 (“[E]ach new amendment to the patent statute represents an opportunity for counterproductive special interest lobbying. Technology-specific patent legislation will encourage rent-seeking by those who stand to benefit from favorable legislation. Patent law has some balance today in part because different industries have different interests, making it difficult for one interest group to push through changes to the statute.” (footnote omitted)).

206. *Id.* at 1577.

207. *Id.* at 1579.

208. CHISUM ET AL., *supra* note 28, at 68-69.

209. See *supra* notes 39-41 and accompanying text.

example, the inventor may merely want to invent, and leave manufacturing, distributing, advertising, and selling to other firms that are more qualified to perform those functions.²¹⁰ Thus, many other parties may need to participate to bring patented products to market.²¹¹ If the rules of patent protection are complicated by industry specific regulation, these potential “partners” in innovation may be less willing to participate, and the utilitarian policy objectives of the patent system²¹² may be thwarted.

B. The Movement to Restrict Patent-Holder Rights in All Fields May Result in Special Tax-Strategy Patent Legislation Being Viewed as Premature

Since at least 2005, Congress has focused on whether patent holders wield too much power, and Congress has been considering ways to “level” the playing field. At least eleven congressional hearings were held from April 2005 to July 2006, on this topic.²¹³ Patent law grants advantages to those who invent a new technology in an industry, and those advantages place other potential producers at a disadvantage.²¹⁴ The extent of the inventor’s advantage has fluctuated over time. Prior to the Patent Act of 1952, many felt that the patent protection provided to inventors was too weak, and therefore failed to adequately promote invention.²¹⁵ The 1952 Patent Act helped strengthen inventors’ rights.²¹⁶ The advantages enjoyed by patent holders

210. Dean Kamen, the president of the corporation that developed the Segway Scooter, testified that his firm prefers to invent, and then “partner with established corporations to manufacture, market, and sell [the] products.” *Patent Trolls: Fact or Fiction?: Hearing Before the Subcomm. on Courts, the Internet, and Intellectual Property of the H. Comm. on the Judiciary*, 109th Cong. 15, June 15, 2006 (prepared statement of Dean Kamen, President, DEKA Research & Dev. Corp.), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_house_hearings&docid=f:28201.pdf.

211. *Id.*

212. See *supra* notes 107-08 and accompanying text (discussing the utilitarian reasons for granting patent protection).

213. See STAFF OF JOINT COMM. ON TAXATION, *supra* note 28, at 3-4 n.10 (listing the various hearings that have been conducted by both houses of Congress).

214. For example, 35 U.S.C. § 271(a) (2000) grants the patent holder the exclusive right to sell an item produced from the invention, or to offer that item for sale, or to use that item. Thus, if other producers wish to sell the item, they must obtain a license from the patent holder (or they can be sued for patent infringement).

215. Tom Arnold, *The Way the Law of Section 103 Was Made*, in CHISUM ET AL., *supra* note 28, at 566 (“[F]or some years prior to the 1952 Patent Act, the actions of the [U.S.] Supreme Court had become so doctrinaire against all patents as to induce Mr. Justice Jackson to opine . . . ‘the only patent that is valid is one which this court has not been able to get its hands upon.’” (quoting *Jungersen v. Ostby*, 335 U.S. 560, 572 (1949))); see also CHISUM ET AL., *supra* note 28, at 535.

216. CHISUM ET AL., *supra* note 28, at 565.

received another boost with the creation of the Federal Circuit which has exclusive jurisdiction over patent appeals.²¹⁷

Currently, many feel that a patent grants the holder too much power. Congress is considering a number of approaches to reduce patent holder power. When introducing the Patents Depend on Quality Act of 2006 (the “PDQ Act”), its sponsor stated, “[i]t is time to restore the balance of power in U.S. patent law.”²¹⁸ The PDQ Act seeks to prevent patent holders who do not actively use their patented invention from profiting from those who used the invention in good faith.²¹⁹ In addition, commentators have presented other proposals that would impact the balance of power between inventors, other producers, and consumers in the applicable market.²²⁰

In addition, the U.S. Supreme Court in 2006 significantly reduced patent-holder rights. Prior to the Court’s decision in *eBay Inc. v. MercExchange, L.L.C.*,²²¹ the Federal Circuit applied a “general rule that courts will issue permanent injunctions against patent infringement absent exceptional circumstances.”²²² With *eBay*, the U.S. Supreme Court made it much more difficult for patent-holders to obtain an injunction. After *eBay*, in order to obtain a permanent injunction against an alleged infringer, the patent holder must satisfy all four requirements traditionally needed to obtain a permanent injunction.²²³

217. See *supra* note 52 and accompanying text.

218. 152 CONG. REC. E524 (daily ed. Apr. 6, 2006) (statement of Rep. Howard L. Berman) (citing *A Patent Injustice: U.S. Court Should Draw Right Lessons from Blackberry Case*, FIN. TIMES, Mar. 27, 2006, at 16).

219. When introducing the PDQ Act, the sponsor stated:

We have learned of countless situations in which patent holders, making no effort to commercialize their inventions, lurk in the shadows until another party has invested substantial resources in a business or product that may infringe on the unutilized invention. The patent troll then steps out of the shadows and demands that the alleged infringer pay a significant licensing fee to avoid an infringement suit.

Id. (statement of Rep. Howard L. Berman).

220. Professor Lemley argues that the strength of the patent-holder’s rights should be related to the benefit which the patent provides to society, and that patent applicants should be able to request a more rigorous examination by the Patent Office which would entitle the inventor to greater rights. See Greg Griffin, *System Patently Out of Date, Some Inventors Complain*, DENVER POST, Apr. 10, 2006, at C01 (proposing that an inventor could seek a “gold-plate[d]” patent that would “[o]ffer better legal protection”). Many commentators have argued that computer software should not be patentable. *Id.*; see also Burk & Lemley, *Policy Levers*, *supra* note 197, at 1632.

221. 126 S. Ct. 1837 (2006).

222. *Id.* at 1839.

223. In setting forth this ruling, the Court stated:

According to well established principles of equity, a plaintiff seeking a permanent

With both Congress and the courts re-examining patent holder rights generally, many may conclude that special legislation to deal with the rights of patent holders in one particular industry, such as tax planning, is premature. The argument is that, rather than diminishing the unity of the U.S. patent statutes by enacting a special statute to prohibit tax strategy patents, the better approach is for Congress to wait and see how the new statutory provisions and the Supreme Court's decision in *eBay* will impact the potential problems with tax strategy patents.

C. International Patent Law Considerations

The United States has been a member of the Trade Related Aspects of Intellectual Property Agreement (the "TRIPS Agreement"), since 1994.²²⁴ Article 27.1 of the TRIPS Agreement provides that "patents shall be available for any *inventions*, whether products or processes in, *all* fields of *technology*"²²⁵

Some commentators have argued that Article 27.1 requires the U.S. patent system to be technology-neutral, and the Patent Office *must* issue patents on all business methods.²²⁶ In response, other commentators have made very persuasive arguments that business methods are not "inventions," and are not part of "technology."²²⁷ Indeed, if Article 27.1 mandates that business

injunction . . . must demonstrate: (1) that it has suffered an irreparable injury; (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) that, considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and (4) that the public interest would not be disserved by a permanent injunction.

Id.

224. Denise W. DeFranco et al., *Technology and the Global Economy: Progress Challenges the Federal Circuit to Define the Extraterritorial Scope of U.S. Patent Law*, 34 AIPLAQ.J. 373, 378-79. The TRIPS Agreement was part of the Uruguay Round of trade negotiations under the General Agreement on Tariffs and Trade (GATT). *Id.*

225. TRIPS Agreement art. 27.1, Apr. 15, 1994, 33 I.L.M. 81, 93 (emphasis added).

226. See Symposium, *Do Overly Broad Patents Lead to Restrictions on Innovation and Competition?*, 15 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 947, 957-58 (2005) ("Our patent system is technology-neutral, so that the same rules have to apply across the board. This is part of our international obligations. We are not allowed to treat different areas differently"); see also Jose I. De Santiago, *Patentability of Business Methods in Mexico*, 14 INT'L L. PRACTICUM 126 (2001); Kuester & Thompson, *supra* note 192, at 685; Gregory J. Maier et al., *An "Opposition" to the Recently-Proposed Legislation Related to Business Method Patents*, 20 J. MARSHALL J. COMPUTER & INFO. L. 397, 398-400 (2002).

227. PAUL GOLDSTEIN, INTERNATIONAL INTELLECTUAL PROPERTY LAW 309 (2001) (arguing that business methods are not "inventions"); John R. Thomas, *The Responsibility of the Rulemaker: Comparative Approaches to Patent Administration Reform*, 17 BERKELEY TECH. L.J. 727, 754 (2002) ("Business methods are assuredly not technologies within the meaning of the TRIPS Agreement. At the time the United States entered the TRIPS Agreement [1994],

methods must be patentable, then the United States was in violation of its TRIPS obligation until 1998 when the Federal Circuit decided *State Street Bank*. Also, the other two major industrial powers which are parties to the TRIPS Agreement, the European Union and Japan, would be in violation of the TRIPS Agreement because they do not provide patent protection for business methods.²²⁸

Nevertheless, the United States, along with other developed nations that are parties to the TRIPS Agreement, frequently argue that third world countries must grant patent protection to U.S. inventors in fields in which the third world countries have not traditionally granted patent protection.²²⁹ Thus, Congress may not want to amend the patent statutes to prohibit patents in one particular industry, because it may signal other TRIPS members that patents need not be granted “in all fields of technology.”²³⁰

V. How the Empire Should Strike Back

A. The Treasury Has No Authority to Eliminate Tax Loophole Patents

The Treasury receives its powers from Congress, and those powers are not broad enough to allow the Treasury to effectively eliminate tax loophole patents. Several interrelated factors combine to limit the Treasury’s effectiveness.

1. The Treasury’s Authority

Congress has made two specific grants of power to the Treasury. First, Congress grants the Secretary of the Treasury the power to enforce and administer the tax laws of the U.S. Government.²³¹ This power is delegated from the Treasury to one of its branches, the Internal Revenue Service.²³² As

patents on business methods were not widely sought, and the common understanding among members of the patent bar was that the patentability of such methods was at best dubious.”).

228. Thomas, *supra* note 227, at 754; *see also* CHISUMET AL., *supra* note 28, at 774 (“[I]n 2003, the European Parliament [in a directive] voted to make software and business methods ineligible for patent protection.”).

229. *See generally* Carlos M. Correa, *The GATT Agreement on Trade-Related Aspects of Intellectual Property Rights: New Standards for Patent Protection*, 16 EUR. INTEL. PROP. REV. 327 (1994). “It was quite evident from the outset of the Uruguay Round that the extension of patentability, particularly to pharmaceuticals, in those countries that did not recognise it was a major objective of the proponents of GATT . . .” *Id.* at 327.

230. TRIPS Agreement art. 27.1, Apr. 15, 1994, 33 I.L.M. 81, 93.

231. I.R.C. § 7801(a)(1) (2000).

232. *See id.* § 7803 (creating within the Treasury a Commissioner of Internal Revenue and giving the Commissioner the power to “supervise the execution and application of the internal revenue laws”); Treas. Reg. § 601.101(a) (as amended in 1996) (“The Internal Revenue Service

a result, the Treasury acts through the IRS to administer and enforce all the provisions of the Internal Revenue Code. If the Internal Revenue Code specifically provided for it, the Treasury, acting through the IRS, could regulate the tax planning behavior of big financial service firms and other inventors.²³³ However, existing law severely restricts the IRS's authority. Under I.R.C. § 6700, the IRS can impose penalties on promoters of "abusive tax shelters,"²³⁴ and financial services firms and others in the tax industry have paid substantial amounts to settle IRS allegations of promoting abusive tax shelters.²³⁵ However, while the Internal Revenue Code authorizes the Treasury to aggressively pursue abusive tax shelter promoters, nothing in the Internal Revenue Code prohibits, or in any way limits, the ability of anyone to obtain and enforce a tax loophole patent.²³⁶ Since the tax laws of the United States are silent on patents, the power to carry out the "administration and

is a bureau of the Department of the Treasury under the immediate direction of the Commissioner of Internal Revenue."); *see also* STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1998, at 18 (1998), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=1998_joint_committee_on_taxation&docid=f:52240.pdf ("The administration and enforcement of the internal revenue laws are performed by or under the supervision of the Secretary of the Treasury. The Secretary has delegated the responsibility to administer and enforce the Internal Revenue laws to the Commissioner." (footnote omitted)). The IRS is also described as a "bureau" of the Treasury. Treas. Reg. § 601.101(a) (stating that "[t]he Internal Revenue Service is a bureau of the Department of the Treasury").

233. However, a regulation could not violate a Constitutional right, such as the freedom of speech. *See* JONATHAN G. BLATTMACHR ET AL., *THE CIRCULAR 230 DESKBOOK* § 4:6.2[c] (2d ed. 2007).

234. I.R.C. § 6700(a) basically imposes a penalty on any person who organizes or participates in the sale of a tax arrangement and "makes or furnishes . . . a statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit . . . which the person knows or has reason to know is false or fraudulent as to any material matter . . ."

235. I.R.S. News Release IR-2001-74 (Aug. 28, 2001), *available at* <http://www.irs.gov/pub/irs-news/ir-01-74.pdf> ("The [IRS] announced today that it has reached an agreement with Merrill Lynch resolving issues relating to tax shelter registration penalties under I.R.C. [§] 6700 Under the terms of the agreement, Merrill Lynch neither admitted nor denied that any . . . transaction was required to be registered . . . [but] Merrill Lynch agreed to make a substantial payment to the [IRS]."); *see also infra* note 270 (discussing settlement payments made by KPMG and Ernst & Young).

236. Given the nature of tax patents, patented tax loopholes will generally be effective in that the patented strategy will allow taxpayers to receive tax benefits. If an inventor obtains a patent, and the IRS or the courts ultimately determine that the strategy does not work, the inventor/tax professional may be publicly criticized, sued by her clients, and may lose the respect of her peers. As a result, inventors of patented tax loopholes likely will not want or need to make false or fraudulent statements about the tax consequences. Thus, I.R.C. § 6700 will not impact tax loophole inventors.

enforcement²³⁷ of the tax laws of the United States does not authorize the Treasury to prohibit tax loophole patents.

Second, Congress grants the Secretary of the Treasury the power to “regulate the *practice of representatives of persons before the Department of the Treasury . . .*”²³⁸ This statutory language imposes two limitations on the Treasury’s ability to regulate: (i) only those who represent persons before the Department of the Treasury can be regulated and (ii) only their “practice” can be regulated. These statutory limitations are not surprising. Administrative agencies typically have the authority to regulate the behavior of persons appearing before the agency,²³⁹ but their ability to regulate others is suspect in the absence of specific statutory authorization.²⁴⁰

The statute provides no definition of either “practice” or “representatives of persons before the Department of the Treasury.”²⁴¹ A related statute provides that attorneys and CPAs can “represent a person before the Internal Revenue Service of the Treasury Department on filing . . . a written declaration . . .”²⁴² The IRS provides a form for this “written declaration,” namely IRS Form 2848 (titled “Power of Attorney and Declaration of Representation”).²⁴³ The Treasury has issued regulations, commonly referred to as “Circular 230,”²⁴⁴ which provide insight into the Treasury’s interpretation of its authority. The Treasury regulations combine the concepts of “representation” and “practice” by frequently using the term “practitioner” to describe those who are

237. I.R.C. § 7801(a).

238. 31 U.S.C. § 330(a)(1) (2000) (emphasis added).

239. “It cannot be disputed that a federal agency can regulate the conduct of attorneys who appear before it.” N.Y. State Bar Ass’n v. FTC, 276 F. Supp. 2d 110, 136 n.22 (D.D.C. 2003).

240. “If you’re not practicing before the agency, then the agency is not licensing your practice . . . I don’t know any other agency where the Federal government seeks to reach out and grab the practice of opinion giving.” Lee A. Sheppard & Sheryl Stratton, *Williams Advocates Tax Accrual Workpaper Policy Changes*, 101 TAX NOTES 323, 326 (2003) (quoting B. John Williams Jr., former Chief Counsel, Internal Revenue Service).

241. 31 U.S.C. § 330.

242. 5 U.S.C. § 500(c). 31 U.S.C. § 330 is made explicitly “[s]ubject to section 500 of title 5 . . .” 31 U.S.C. § 330.

243. Although neither the statute nor the regulations specifically refer to IRS Form 2848, leading commentators state that the “written declaration” is typically made on IRS Form 2848. See ROBERT E. MELDMAN & RICHARD J. SIDEMAN, *FEDERAL TAXATION: PRACTICE AND PROCEDURE* ¶ 211, at 29 (7th ed. 2004) (“Because [representative] acts constitute practice before the IRS, they can only be performed . . . when evidence of authorization to perform such acts has been furnished to the IRS. The Power of Attorney, Form 2848 . . . is generally used for such authorization.”); see also BLATTMACHR ET AL., *supra* note 233, § 4:6.2[c] (stating that in addition to the Form 2848, the IRS Form 706, the United States Estate Tax Return, may also constitute a “written declaration.”).

244. 31 C.F.R. pt. 10 (2007). The Office of the Director of Practice, established by the Secretary of the Treasury, enforces the Circular 230 regulations. See 31 C.F.R. § 10.1.

regulated.²⁴⁵ The phrase “practice before the Internal Revenue Service” is defined in the regulations to

comprehend[] all matters connected with a presentation to the [IRS] . . . relating to a taxpayer’s rights, privileges, or liabilities under laws or regulations administered by the [IRS, including, but] not limited to, *preparing* and filing documents, corresponding and communicating with the [IRS], and representing a client at conferences, hearings, and meetings.²⁴⁶

While this regulatory definition of “practice” is broad,²⁴⁷ it cannot expand the Treasury’s power beyond the statute.²⁴⁸

The regulations then describe the four primary groups “who may practice:”

(1) An attorney who files a written declaration with the IRS specifying the party or parties “on whose behalf he or she acts;”

(2) A CPA who files a written declaration with the IRS specifying the party or parties “on whose behalf he or she acts;”

(3) An enrolled agent (who has voluntarily taken a written examination); and

(4) An enrolled actuary who files a written declaration with the IRS specifying the party or parties “on whose behalf he or she acts.”²⁴⁹

245. *See infra* notes 250-51 and accompanying text.

246. 31 C.F.R. § 10.2(d).

247. This definition of “practice” raises many issues about the Treasury’s authority to regulate. First, when is a tax return preparer a “representative of a person before the [IRS]” under 31 U.S.C. § 330(a)(1)? The Treasury Regulations state that one need not be a “*practitioner*” (in other words an attorney, CPA, or enrolled agent) to prepare a tax return. *See* 31 C.F.R. § 10.7(e) (stating that “[a]ny individual may prepare a tax return”). These regulations, however, impose various requirements on *practitioners* who prepare tax returns. *See* 31 C.F.R. § 10.22(a) (stating that “[a] practitioner must exercise due diligence [in] preparing or assisting in the preparation of . . . tax returns”); 31 C.F.R. § 10.34 (stating that “[a] practitioner may not sign a tax return as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits”). Second, and more important for this analysis, when is a person who provides tax advice engaged in “practice” under the Treasury Regulations, and when is that person a “representative of a person before the [IRS]” under 31 U.S.C. § 330(a)(1)? The language of 31 C.F.R. § 10.1(d) is broad enough—“all matters connected with a presentation to the [IRS]”—to include within “practice” any tax advice that leads a taxpayer to take a position on a tax return, but is a mere tax advisor a “representative” on behalf of the taxpayer before the IRS?

248. If a regulation contradicts a statute, the statute governs. *See Swallows Holding, Ltd. v. Comm’r*, 126 T.C. 96, 132 (2006) (“Where, as here, the Secretary [of the Treasury] has prescribed a regulation that is inconsistent with the plain meaning of a statute, the regulation is invalid . . .”).

249. 31 C.F.R. § 10.3(a). Other individuals are eligible to practice under certain circumstances. *See* 31 C.F.R. §§ 10.3(e), 10.5(d), 10.7. These provisions allow a person to

These individuals are described as “practitioners” in the regulations.²⁵⁰ The Treasury regulations generally regulate the “practice” of these “practitioners.”²⁵¹ Based on the statutory and regulatory language, it is clear that an attorney, CPA, enrolled agent, or enrolled actuary who currently “represents” a taxpayer in an IRS audit pursuant to an IRS Form 2848 is a “practitioner” whose “practice” may be regulated by the Treasury. However, beyond this narrow situation, the Treasury’s ability to regulate is dubious.

If an attorney or CPA never files an IRS Form 2848 and never represents a taxpayer during an IRS audit, he or she does not appear to be a taxpayer’s “representative” whose conduct could be regulated by the Treasury.²⁵² Also, if the attorney or CPA has affirmatively withdrawn from representing taxpayers, and revoked every outstanding IRS Form 2848 that she has signed,²⁵³ or the statute of limitations has expired with respect to all tax years for which she signed a Form 2848,²⁵⁴ the attorney or CPA is no longer a “representative,” and the Treasury should no longer be able to regulate her activities. Furthermore, commentators have argued that if an attorney or CPA has not actively participated as a taxpayer’s representative for some time, the attorney or CPA should no longer be considered a taxpayer’s “representative.”²⁵⁵

“represent” himself or herself; allow an individual to represent a member of his or her immediate family, and allow employees and certain other individuals to represent an entity.

250. 31 C.F.R. § 10.2(e).

251. See 31 C.F.R. § 10.20(a) (practitioners must provide certain information to the IRS upon request); § 10.21 (a practitioner must advise a client about errors or omissions); § 10.22 (a practitioner must exercise due diligence); § 10.27(a) (a practitioner may not charge an unconscionable fee for representing a client).

252. BLATTMACHR ET AL., *supra* note 233, § 4:6.2, at 4-12 (“In any case, it seems to be a critical point that, because the Circular applies only to ‘Practitioners’ as defined above, the term excludes a lawyer or CPA who does not file the form [2848].”).

253. The IRS provides specific guidance detailing how an attorney or CPA may withdraw from a representation. See INTERNAL REVENUE SERVICE, INSTRUCTIONS FOR FORM 2848 (2004), available at <http://www.irs.gov/pub/irs-pdf/i2848.pdf>. The attorney or CPA can file a copy of the original Form 2848 and write “REVOKE” across the top, and “[t]he statement of . . . withdrawal must indicate that the authority of the power of attorney is revoked, list the tax matters, and must be signed and dated by the taxpayer or representative.” *Id.* at 2.

254. When preparing Form 2848, the taxpayer and the representative specifically designate the tax years and the tax matters for which the attorney or CPA can represent the taxpayer before the IRS. *Id.* at 3. For example, Alice Attorney and Tom Taxpayer might have signed a Form 2848 providing that Alice is authorized to represent Tom with respect to Tom’s 2001 income tax liability on IRS Form 1040. In 2008, if the statute of limitations has expired on Tom’s 2001 tax return, Alice is no longer authorized to represent Tom. See I.R.C. § 6501 (2000) (regarding the statute of limitations for tax matters generally).

255. Commentators state:

The Circular does not specify whether a lawyer or CPA who has previously filed

The American Jobs Creation Act of 2004 complicated the analysis by adding the following language at 31 U.S.C. § 330(d):

Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of *written advice* with respect to any entity, transaction, plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion.²⁵⁶

This new provision raises several issues: Is this provision intended to expand the Treasury's authority? What is the difference between the authority to "impose standards" under 31 U.S.C. § 330(d), and the authority to "regulate" under 31 U.S.C. § 330(a)? Is the Treasury authorized to regulate the "rendering of written advice" even if it is not in connection with the representation of a taxpayer before the IRS? Can the Treasury regulate any "written advice" provided in connection with tax planning before the taxpayer has even filed a tax return? Can the Treasury regulate "written advice" by someone who does not represent taxpayers before the IRS? What is "advice"?

The applicable legislative history provides no guidance.²⁵⁷ However, the

a [Form 2848] . . . continues to be treated as a "Practitioner" if the representation of the taxpayer has ended. . . . In any case, personnel at the IRS Office of Professional Responsibility (OPR) . . . [say] that a Practitioner cannot take any action that would eliminate him or her as a Practitioner—in other words, OPR has advised that once an accountant or lawyer is a Practitioner under the Circular, he or she is always under it unless he or she is disbarred pursuant to it.

This position would seem to be an overreaching exercise of regulatory authority to the point of having Constitutional implications as an unauthorized restriction of free speech.

BLATTMACHR ET AL., *supra* note 233, § 4:6.2, at 4-12.

256. American Jobs Creation Act of 2004 § 822(b), 31 U.S.C. § 330(d) (Supp. IV 2004)). The Act also grants the Secretary of the Treasury the power to impose a monetary penalty up to the "gross income derived (or to be derived) from the conduct giving rise to the penalty . . ." 31 U.S.C. § 330(b) (Supp. IV 2004)). Prior to 2004, sanctions were limited to suspension, disbarment, or censure. *See* 31 U.S.C. § 330(b) (2000); 31 C.F.R. § 10.50.

257. *See* H.R. REP. NO. 108-548, pt. 1 (2004); H.R. REP. NO. 108-755 (2004) (Conf. Rep.); *see also* S. REP. NO. 108-257 (2004). The legislative history uses the term "tax advisors" rather than "practitioners."

REASON FOR CHANGE

The Committee believes that it is critical that the Secretary have the authority to censure *tax advisors* as well as to impose monetary sanctions against *tax advisors* because of the important role of *tax advisors* in our tax system. Use of these sanctions is expected to curb the participation of *tax advisors* in both tax shelter activity and any other activity that is contrary to Circular 230 standards.

Treasury Regulations implementing the 2004 Act only seek to regulate “practitioners,”²⁵⁸ and those who supervise “practitioners.”²⁵⁹ Thus, even after the 2004 amendments, the Treasury still seeks to regulate only attorneys, CPAs and the other specifically listed representatives.

While it is not entirely clear, strong arguments can be made that the addition of 31 U.S.C. § 330(d) does not significantly expand the Treasury’s authority for purposes of prohibiting patents. First, the statutory language does not indicate that a new power is being granted, but rather states that “Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury”²⁶⁰ Second, the provision only permits the Treasury to “impose standards,”²⁶¹ which does not suggest the power to prohibit tax inventors from obtaining and licensing patents.

2. Firms Inventing Tax Loopholes Can Avoid Regulation by the Treasury

The statutes and regulations discussed above indicate that three conditions generally must be met in order for the Treasury to regulate. First, the individual involved must be an attorney, CPA, enrolled agent,” or enrolled actuary.²⁶² Second, the person must have filed an IRS Form 2848 to represent a taxpayer before the IRS.²⁶³ And third, the person must be engaged in “matters connected with a presentation to the [IRS].”²⁶⁴

As a result, even if the Treasury adopted regulations prohibiting patents on tax strategies, inventors likely could avoid the prohibition. First, big financial service firms can use professionals other than attorneys or CPAs to invent.²⁶⁵

EXPLANATION OF PROVISION

. . . .

The provision also confirms the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

S. REP. NO. 108-257, at 6 (emphasis added).

258. BLATTMACHR ET AL., *supra* note 233, § 4:6.2 n.10, at 4-8 n.10 (“The Circular applies, with exceptions not relevant here, only to Practitioners”); *id.* § 4:5, at 4-9 (“[I]ndividuals who are not Practitioners . . . are not required, in general, to follow the Circular . . . even if they prepare [tax] returns for compensation.”).

259. 31 C.F.R. § 10.36.

260. 31 U.S.C. § 330(d).

261. *Id.*

262. 5 U.S.C. § 500; 31 C.F.R. § 10.3(a)-(d); *see also supra* note 249 (discussing other persons who may represent a taxpayer before the IRS).

263. 5 U.S.C. § 500; *see also supra* notes 252-55 (indicating that IRS Form 2848 is the typically used “written declaration” under 5 U.S.C. § 500 and 31 C.F.R. § 10.3(a)-(d)).

264. 31 C.F.R. § 10.2(d).

265. The individual inventor must sign the patent application. *See* 35 U.S.C. § 115; 37

Second, even if lawyers or CPAs working for a big financial services firm want to invent, they could revoke any outstanding Form 2848s and no longer represent taxpayers before the IRS.²⁶⁶ Third, big financial service firms might even establish separate subsidiary entities to legally isolate their inventors from any professionals who might be subject to Treasury regulation. Also, it could be argued that inventing a tax loophole, applying for a patent, and licensing a patent, are not “matters connected with a presentation to the [IRS]”²⁶⁷ Finally, and perhaps most fundamental, one can question whether a court would interpret the statutes to allow the Treasury to regulate an activity that is so far removed from actually “practicing” before the agency.²⁶⁸

3. CPA Firms and Law Firms Inventing Tax Loopholes Can Also Avoid Regulation by the Treasury

The “Big Four” CPA firms wield substantial power in the tax planning market,²⁶⁹ and have demonstrated great ingenuity many times.²⁷⁰ Although

C.F.R. § 1.63(a); *see also* CHISUM ET AL., *supra* note 28, at 81 n.11 (“The oath or declaration must usually be signed by the inventor, and must state that the inventor has (1) read the application, (2) believes he is the first inventor, and (3) acknowledges the duty to disclose any material information.”). However, it likely would be practically impossible for any person who was not directly involved in the inventive process to seriously challenge whether the person signing the patent application was the true inventor.

266. BLATTMACHR ET AL., *supra* note 233, § 4:6.1, at 4-10 (“Becoming a Practitioner is voluntary and requires filing [IRS Form 2848] with the IRS”). However, Treasury officials may argue that once an attorney or CPA is a “practitioner,” the individual always will be subject to the Treasury’s authority. *See supra* note 255.

267. 31 C.F.R. § 10.2(d).

268. *See supra* note 240.

269. After the demise of Arthur Andersen, the “Big Four” are Ernst & Young, KPMG, PricewaterhouseCoopers, and Deloitte & Touche. *See* H. Beau Baez III, *The Rush to the Goblin Market: The Blurring of Quill’s Two Nexus Test*, 29 SEATTLE U. L. REV. 581, 627 n.282 (2006).

270. In regards to KPMG, an IRS News Release states,

[KPMG] has admitted to criminal wrongdoing . . . as part of an agreement to defer prosecution of the firm

. . . .
In the largest criminal tax case ever filed, KPMG has admitted that it engaged in a fraud that generated at least \$11 billion dollars in phony tax losses In addition to KPMG’s former deputy chairman, the individuals indicted today include two former heads of KPMG’s tax practice

. . . .
The criminal information and indictment together allege that from 1996 through 2003, KPMG . . . conspired to defraud the IRS by designing, marketing and implementing illegal tax shelters.

I.R.S. News Release IR-2005-83 (Aug. 29, 2005), *available at* <http://www.irs.gov/pub/irs-news/ir-05-083.pdf>; *see also* I.R.S. News Release IR-2003-84 (July 2, 2003), *available at* <http://www.irs.gov/pub/irs-news/ir-03-84.pdf> (“The [IRS] today announced a closing agreement

none of the patents issued under classification 705/36T as of January 22, 2008 were issued to the Big Four CPA firms, if recent history is any indication, one can expect the Big Four CPA Firms to develop many tax loopholes.

Tax attorneys may also invent tax loopholes. If the Treasury amended Circular 230 to prohibit tax strategy patents, the attempt likely would not deter CPA firms or law firms, for many of the reasons discussed above. Inventive CPAs and attorneys could avoid representing taxpayers before the IRS (and withdraw any outstanding IRS Form 2848s). Likewise, the inventors could be segregated into a separate legal entity, and a court likely would declare the Treasury's attempt invalid because it would exceed the Treasury's statutory authority²⁷¹ as tax loophole inventing, patenting, and licensing seem far removed from the "practice of representatives of persons before the Department of the Treasury."²⁷²

B. The Treasury's Current Regulation of Contingent Fees Is Inadequate

A patent holder frequently licenses the right to use patented technology to those who can generate profits using the innovation.²⁷³ These licensing arrangements typically provide for the licensee to pay royalties to the patent-holder contingent on the gross revenue or net profits generated by the patented product.²⁷⁴ Contingent payments make economic sense for both the licensee

with Ernst & Young, LLP, resolving issues relating to an examination of Ernst & Young's compliance with the registration and list maintenance requirements regarding the firm's marketing of tax shelters. The agreement requires Ernst & Young to make a non-deductible payment of \$15 million."); *Washington Alert*, FED. TAXES WKLY. ALERT, July 3, 2002, at 12, 13 ("IRS and Pricewaterhouse Coopers LLP have reached an agreement on issues relating to tax shelter registration . . . The accounting firm agreed to make 'a substantial payment' to IRS to resolve issues concerning advice given to clients . . .").

271. See *supra* notes 265-68 and accompanying text.

272. 31 U.S.C. § 330(a)(1) (2000).

273. Except in rare circumstances, a patent holder is not required to license an invention. In those rare situations, the patent holder is said to issue a "compulsory license" to the user. See, e.g., *Vitamin Technologists, Inc. v. Wis. Alumni Research Found.*, 146 F.2d 941 (9th Cir. 1944) (The patented technology was needed to eliminate the rickets disease; the court refused to enjoin the use of the product.); *City of Milwaukee v. Activated Sludge*, 69 F.2d 577 (7th Cir. 1934) (The patent holder held a patent on a method for treating sewage. The court refused to grant an injunction because if the City of Milwaukee had been enjoined from using the process, it would have been forced to dump large quantities of raw sewage into Lake Michigan.). It might be argued that the U.S. Supreme Court's opinion in *eBay Inc. v. MercExchange, L.L.C.*, 126 S. Ct. 1837 (2006), will make it significantly more difficult for a patent holder to obtain an injunction, and as a result, more patent holders *must* license their innovations (because they cannot prevent others from using the invention, and can only collect money damages for infringement).

274. In a contingent arrangement, if the licensee makes no sales or earns no profit, the licensee would not be obligated to pay any royalties. On the other hand, if the licensee is

and the patent-holder. Since the patented innovation is new (at least initially), there can be substantial uncertainty surrounding whether the innovation can be used to generate a profit or other benefit.²⁷⁵ In light of this uncertainty, the parties will be drawn to a contingent arrangement. The licensee will be reluctant to pay a flat fee to use the patented innovation without knowing the level of sales, profits or other benefits that will be generated. The patent holder may agree to receive contingent payments in the hope of receiving a huge pay-off if the licensee is successful.

Before the mass media began publicizing the availability of tax loophole patents,²⁷⁶ the Treasury began an assault on contingent payments for tax assistance. In 2002, the Treasury amended the Circular 230 regulations to provide that “[a] practitioner may not charge a contingent fee . . . for any advice rendered in connection with a position taken or to be taken on an original tax return.”²⁷⁷ The Treasury added this restriction to encourage greater independence by tax practitioners.²⁷⁸ The Treasury expanded this prohibition

successful, the patent-holder could receive substantial royalties based on a percentage of sales (or net profits). *See, e.g.*, *Promega Corp. v. Lifecodes Corp.*, 53 U.S.P.Q.2d (BNA) 1463 (D. Utah 1999) (The patent holder argued for a royalty rate of 40% to 49%; the infringer argued that a reasonable royalty rate would be 10%; the court applied a 22% rate to set the damages for infringement.). The prevalence of this practice is reflected in I.R.C. § 1235(a), which basically provides that the licensing of a patent in exchange for payments that are “contingent on the productivity, use or disposition” can be considered a “sale” for income tax purposes. Furthermore, the patent statute provides that damages for patent infringement shall be no less than a “reasonable royalty for the use made of the invention by the infringer” 35 U.S.C. § 284. Courts have considered up to fifteen factors in determining what constitutes a reasonable royalty. *See Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970), *aff’d as modified*, 446 F.2d 295 (2d Cir. 1971).

275. Even after the patented technology has been used for a period of years, a substantial degree of uncertainty can remain. If a new invention comes out tomorrow, the old patented technology may suddenly become worthless.

276. *See Wendy Davis, Patenting Tax Strategies*, TRUSTS & ESTATES, Mar. 2004, at 42; Deborah L. Jacobs, *Patent Pending: As Estate Planning Heats Up, It May Not Be Enough to Invent a Brilliant Tax-Saving Technique for Your Clients. You May Need to Patent It, Too.*, BLOOMBERG WEALTH MANAGER, May 2005, at 40; Rachel Emma Silverman, *Lawyers, Financial Advisors Are Getting Exclusive Rights to Estate-Planning Strategies*, WALL ST. J., June 24, 2004, at D1.

277. 31 C.F.R. § 10.27(b)(2) (2007).

278. “The Treasury Department and the IRS continue to believe that a rule restricting contingent fees . . . is appropriate in light of concerns regarding attorney and auditor independence.” Regulations Governing Practice Before the Internal Revenue Service, 71 Fed. Reg. 6421, 6423-24 (proposed Feb. 8, 2006) (preamble to notice of proposed rulemaking). If the practitioner’s fee depends on a tax strategy’s success, presumably the practitioner’s objectivity may be compromised.

in 2007, stating that the restrictions on contingent fees will “support [] voluntary compliance”²⁷⁹

However, since this rule is part of Circular 230, big financial service firms and others can avoid these rules using the methods described earlier in this Article.²⁸⁰

However, the Treasury has adopted a different rule aimed at contingent fee arrangements that may inconvenience users of patented tax strategies. The Internal Revenue Code provides that the Treasury has authority to (i) require taxpayers to file tax returns, and (ii) specify the information that a taxpayer must include on his or her tax return.²⁸¹ Under this authority, the Treasury adopted Regulations which require any taxpayer that pays a fee that is “contingent on the taxpayer’s realization of tax benefits from the transaction,” to file a separate disclosure statement.²⁸² This separate disclosure statement, IRS Form 8886, must not only be attached to the taxpayer’s tax return, but the

279. The Treasury published its proposed regulations in 2006. See Regulations Governing Practice Before the Internal Revenue Service, 71 Fed. Reg. at 6429 (to be codified at 31 C.F.R. pt. 10). The rules were approved on September 19, 2007, with an effective date of September 26, 2007. See Regulations Governing Practice Before the Internal Revenue Service, 72 Fed. Reg. 54,540 (Sept. 26, 2007) (to be codified at 31 C.F.R. pt. 10). Under these new regulations, a practitioner would be prohibited from charging a contingent fee except in two specific situations that involve tax “defense” rather than tax “planning.” First, a practitioner could agree to represent a client during an IRS audit for a contingent fee. *Id.* at 54,548 (to be codified at 31 C.F.R. § 10.27(b)(2)). Second, a practitioner could “charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.” *Id.* (to be codified at 31 C.F.R. § 10.27(b)(4)).

280. See *supra* notes 265-68 and accompanying text. As long as the inventor is not subject to Circular 230, the inventor could charge the taxpayer, the taxpayer’s attorney, and the taxpayer’s CPA, a license fee for using the patented technology. For example, the Wealth Transfer Group, a “financial services firm for very wealthy individuals and families,” has obtained a patent on a tax strategy called the “GRAT” or “SOGRAT.” Silverman, *supra* note 276, at D2; see also Jacobs, *supra* note 276, at 42 (referring to Wealth Transfer Group’s patent as being one for a SOGRAT). In order to implement the SOGRAT strategy, the taxpayer’s attorney needs to prepare a trust document satisfying various requirements. *Id.* (referring to U.S. Patent No. 6,567,790 (filed Dec. 1, 1999)). The Wealth Transfer Group has aggressively demanded royalty payments from attorneys and CPAs for the right to use the technique. *Id.* at 42 (noting that at least fourteen large law firms are paying license fees to the Wealth Transfer Group to use the SOGRAT). Also, the Wealth Transfer Group has sued John W. Rowe, the former executive chairman of Aetna, Inc., for using the strategy without its permission. *Wealth Transfer Group v. Rowe*, No. 3:06CV00024(AWT) (Mar. 9, 2007); see also Seidenberg, *supra* note 187, at 44 (regarding the results of that litigation).

281. See I.R.C. § 6011(a) (2000).

282. Treas. Reg. § 1.6011-4(b)(4)(i) (as amended in 2006). This reporting obligation applies if the person receiving the contingent fee “make[s] or provide[s] a statement, oral or written, to the taxpayer or a related party . . . as to the potential tax consequences that may result from the transaction.” *Id.* § 1.6011-4(b)(4)(ii).

taxpayer must send an extra copy to the IRS Office of Tax Shelter Analysis (OTSA).²⁸³ The IRS Form 8886 requires the taxpayer to disclose the “facts of the transaction that related to the expected tax benefits,” to “[d]escribe the expected tax benefits,” and to “estimate [] the amount of each of the expected tax benefits”²⁸⁴ While this reporting requirement technically does not restrict the use of contingent fee arrangements, a taxpayer may be reluctant to engage in a transaction that will focus increased IRS attention on his or her tax return.

While the reporting of contingent fee arrangements on IRS Form 8886 may provide the Treasury with some information about tax loophole patents, it will not provide the information needed. First, some taxpayers using patented tax loopholes may not file Form 8886, arguing that they do not pay a contingent fee.²⁸⁵ Second, nothing on Form 8886 requires the taxpayer to describe the patent claims or even provide the patent number. Thus, the IRS will not be able to clearly determine which Form 8886 relates to which patented tax loophole. Third, taxpayers may use contingent fee arrangements in many situations in which patented tax loopholes are not involved.²⁸⁶ Thus, it would be extremely difficult for the IRS to identify the amount of tax saved from particular patented loopholes under current rules.

C. The IRS Should Require Taxpayers to “Red Flag” Their Tax Returns and Provide Detailed Information If They Use a Patented Tax Strategy

As discussed above, patented tax loopholes will allow taxpayers to surprise the U.S. government,²⁸⁷ and the current regulations for reporting contingent fee arrangements are inadequate for gathering information about patented tax loopholes.²⁸⁸ Congress passes tax laws with the expectation that a certain amount of tax revenue will be raised. Tax inventors find ways for the super-rich to avoid paying the projected amount of tax. Congress (and the IRS) see the revenue short-fall, but in the absence of detailed taxpayer reporting, will

283. *Id.* § 1.6011-4(d), (e).

284. See I.R.S. Form 8886, Reportable Transaction Disclosure Statement (OMB No. 1545-1800) (Rev. Dec. 2005), available at <http://www.irs.gov/pub/irs-pdf/f8886.pdf>.

285. The description of when a fee is “contingent” is broad. Even if the fee otherwise is fixed, the fee is deemed contingent if “the taxpayer or a related party . . . has the right to a full or partial refund of fees . . . if all or part of the intended tax consequences from the transaction are not sustained.” Treas. Reg. § 1.6011-4(b)(4)(i).

286. These regulations regarding contingent fee arrangements were adopted even before the popular press began discussing the availability of patent protection for tax strategies. See *supra* note 276 and accompanying text.

287. See *supra* notes 96-102 and accompanying text.

288. See *supra* Part V.B.

not know the practical impact of particular patented tax loopholes.²⁸⁹ In the absence of detailed information, Congress and the Treasury will not be able to precisely target remedies to address the revenue short-fall, and the end result may be that a greater portion of the U.S. tax burden will shift from the super-rich to other taxpayers.²⁹⁰

As a result, this Article proposes that the Treasury require that taxpayers provide detailed information when they use patented tax strategies. This information would only be required if the process actually reduces the taxpayer's tax liability. Reporting would not be required when the patented process merely facilitates tax reporting or tax compliance.²⁹¹

The current Treasury regulations require disclosure of contingent fee arrangements, and the use of tax techniques protected by trade secret law,²⁹² but more extensive disclosure should be required when a taxpayer uses a patented tax strategy. Taxpayers should be required to provide the following information on a new form, which could be referred to as the "Patented Strategy Disclosure Form:"

- (1) Information identifying the taxpayer;²⁹³
- (2) Information identifying the tax year and the tax form on which the tax benefit was realized;

289. The Treasury can certainly review tax patents when issued. At congressional hearings in July 2006, the IRS Commissioner said the IRS will monitor issued tax patents, but unfortunately, the IRS's focus is on identifying whether any patented strategy violates existing tax laws and will lead to an abusive tax shelter. *Patenting of Tax Advice Hearings, supra* note 4, at 13 (statement of Mark Everson, Comm'r, Internal Revenue Service) (stating that the results of IRS searches of existing patents revealed that "none of the . . . patents were found to be abusive tax avoidance transactions"). As noted above, tax inventors likely will not patent tax strategies that do not work. *See supra* note 236. Even if the Treasury reviewed issued patents with the intention of estimating potential revenue short-falls, that estimation process would be very difficult as the revenue short-fall will depend on a variety of factors, including the marketing expertise of the inventor (or persons hired by the inventor or the inventor's employer), the size of the market for the technique, the willingness of taxpayers and their advisors to pay to use the patented process, and other factors.

290. *See supra* Part III.B.

291. Also, this reporting would not be required if the tax treatment is merely a feature of the invention, and does not actually save taxes or otherwise provide a tax benefit. For example, while the invention considered in *State Street Bank & Trust Co. v. Signature Financial Group*, 149 F.3d 1368 (Fed. Cir. 1998), involved a tax feature, *see supra* notes 103-06 and accompanying text, the tax feature did not reduce the amount of tax otherwise payable. As a result, the use of that type of patented process would not require additional information reporting.

292. Treas. Reg. § 1.6011-4(b)(3), (4) (as amended in 2006) (requiring disclosure on IRS Form 8886).

293. This information would include the taxpayer's name, address, and social security number or other tax identification number.

(3) Information about the taxpayer's income level, trade or business, and other key tax characteristics;²⁹⁴

(4) Information identifying any separate taxable entity—such as a partnership, S corporation, taxable trust, or charity—used in connection with the patented process;

(5) Information identifying the inventor, the patent holder and all other persons who provided tax advice or otherwise participated in the transaction;

(6) The patent number; and

(7) A narrative description of the facts of the transaction, the nature of the expected tax benefit, and an estimate of the amount of the tax benefit.²⁹⁵

The Patented Strategy Disclosure Form would be filed with the Office of Tax Shelter Analysis or another office designated by the Treasury.

With this information, the Treasury could estimate the revenue impact of each patented tax loophole, as well as the class of taxpayers who benefit from the patented loophole. The Treasury could inform Congress on how the patented loophole is causing actual tax receipts to deviate from the tax receipts that Congress had anticipated. Hopefully Congress would then use this information to modify the tax laws to allocate the tax burden appropriately among the super-rich and other taxpayers.²⁹⁶

A remaining problem would be the time lag between the time the IRS received the relevant information and the time Congress could react. The Patent Office may issue a patent on a tax loophole in 2008; an individual may license the loophole and save income taxes on his or her 2008 income tax return; the taxpayer will file his or her income tax return in April 2009 (or in October of 2009 if the taxpayer extends the due date for filing the return);²⁹⁷ the Treasury could start reviewing the patented strategy disclosure forms in late 2009 and a number of steps would still remain before Congress could enact corrective legislation.²⁹⁸ Although this time lag is unfortunate, the

294. The IRS may be able to use the taxpayer's social security number (or other tax identification number) to find the taxpayer's tax return, but it may be more convenient if key information is provided directly on the patented strategy disclosure form.

295. IRS Form 8886 requests narrative descriptions of the facts of the transaction and the estimated tax benefits.

296. A key tax policy goal is "vertical equity"—allocating the tax burden fairly among the super-rich, the wealthy, and other groups. *See* NEWMAN, *supra* note 183, at 25 ("Vertical equity invites an inquiry into the impact of the tax provision on different income levels.").

297. I.R.C. § 6161(a)(1) (2000).

298. The Treasury would need to analyze the information on the patented strategy disclosure forms. The Treasury would need to total the tax saved with each patented tax loophole, and identify which group of taxpayers is using the loophole. For example, is the loophole used by those who file Schedule C (for a separate trade or business); by those who use partnerships; by those whose income exceeds certain levels; by those whose itemized deductions exceed certain

process could still alleviate some of the concerns posed by the loophole patents.²⁹⁹ If Congress and the Treasury merely see a drop in revenue, there may be significant pressure for an across-the-board tax increase. In contrast, armed with information that particular groups among the super-rich have avoided specific amounts of tax through the use of patented tax loopholes, the Treasury and Congress can either attempt to close the loophole, or otherwise increase taxes appropriately for that super-rich group of taxpayers.

The Treasury already requires specific disclosure when a tax strategy protected by trade secret law is used.³⁰⁰ As a result, the Treasury should not be reluctant to impose disclosure requirements when a taxpayer uses a technique protected by a different form of intellectual property, namely patent protection. Perhaps as a preliminary step, the IRS has requested public comments on a proposed regulation that would require taxpayers using patented tax planning methods to file the existing IRS Form 8886.³⁰¹

VI. Conclusion

Although congressional hearings in July 2006 considered various consequences from patenting tax advice, key policy considerations were ignored. Offering patents for tax loopholes will cause big financial service firms and other inventors to develop shocking new tax loopholes for the super-

levels; by those who invest in real estate? The Treasury would need to determine the appropriate action—should the loophole be closed through legislation? Or should a different approach be used to raise more tax revenue from the group of taxpayers involved? The Treasury would then convey all this information to Congress; statutory language would need to be prepared and analyzed, and all the other steps involved with enacting legislation would need to be followed.

299. *See supra* note 150 and accompanying text (discussing the Tax Reform Act of 1986).

300. Treas. Reg. § 1.6011-4(b)(3) (as amended in 2006). The IRS Form 8886 must be completed and filed if the taxpayer uses a tax strategy under “conditions of confidentiality” and pays an advisor a “minimum fee.” A transaction is used under “conditions of confidentiality” if

[T]he advisor who is paid the minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor’s tax strategies. A transaction is treated as confidential even if the conditions of confidentiality are not legally binding on the taxpayer.

Treas. Reg. § 1.6011-4(b)(3)(ii). The minimum fee is \$250,000 if the taxpayer is a corporation (or a partnership in which all the owners are corporations), or \$50,000 in other situations. *Id.* § 1.6011-4(b)(3)(iii).

301. 72 Fed. Reg. 54615 (Sept. 26, 2007) (to be codified at 26 C.F.R. § 301.6111-4(b)(7)). As discussed above, merely requiring IRS Form 8886 will not provide the IRS with adequate information. A separate Patented Strategy Disclosure Form should be required. *See supra* text accompanying notes 292-96.

rich because the super-rich can pay big royalties. This will cause congressional revenue estimates to fall short of projected targets. If not appropriately monitored, Congress may respond with tax laws that will not only increase tax revenues, but shift tax burdens from the super-rich to all other taxpayers. Moreover, offering patents on tax loopholes will increase the complexity of our tax laws, and more and more taxpayers will “drop out” of the U.S. tax system by resorting to offshore tax gimmicks, barter exchange schemes, and other illegal scams used to evade U.S. taxation.

These fundamental policy problems should be considered when determining government policies toward patenting tax loopholes. This Article argues that since Congress is unlikely to prohibit tax loophole patents in the near future,³⁰² the Treasury should require that taxpayers using patented tax strategies inform the IRS about the patented tax strategy and the tax benefits derived. With this information, the Treasury and Congress can make more knowledgeable decisions regarding revenue collection.

302. *See supra* Part IV.