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THE PATENTED LOOPHOLE: HOW SHOULD CONGRESS RESPOND TO THIS JUDICIAL INVENTION?

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A patent is an artificial device that encourages inventions. The introduction of patent protection into an industry is appropriate when inventions in that industry otherwise would be produced at suboptimal levels. The Patent Office recently started issuing patents on tax loopholes, providing a new and incredibly powerful economic incentive that will encourage tax gurus[1] to invent loopholes at unprecedented rates. This Article asserts that there is no need to provide patents to encourage tax gurus to invent more tax loopholes. Congress should prohibit patent-holders from collecting damages based on the tax savings generated from the use of a patented process.

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1. "'[T]he term guru is generally reserved for two types of individuals—spiritual guides for followers of Eastern religion and tax advisers for adherents of Western capitalism.'" Jeffery L. Yablon, *As Certain as Death—Quotations About Taxes (2006 Edition)*, 110 TAX NOTES 103, 158 (2006) (quoting Franklin L. Green).

I. INTRODUCTION

An IRS spokesperson "questioned whether the [Patent Office][2] staff has adequate background in tax law . . . to properly rule on those patent applications [for tax strategies]."[3]

In response, a Patent Office spokesperson said, "The [Patent Office] has a long tradition of evaluating the unfamiliar . . . . 'We've been dealing with emerging technologies for 200-plus years.'"[4]

Welcome to the Age of the Patented Loophole![5] The Patent Office is

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2. The U.S. Patent and Trademark Office will be referred to in this Article as the "Patent Office." *See* Mark A. Lemley, *Rational Ignorance at the Patent Office*, 95 NW. U. L. REV. 1495, 1495 n.* (2001) ("Yes, I know it's the Patent and Trademark Office, not the Patent Office. But nothing in this [Article] applies to the PTO's trademark operations, and besides being awkward, using the full title might be misleading.").

3. Robert Goulder, *IRS Looking to Prevent Patents on Tax Advice*, 109 TAX NOTES 737, 737 (2005) (referring to comments made by Josephine M. Bonaffini, the program manager of the IRS estate and gift tax program).

4. 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, 48 (asking Brigid Quinn of the Patent Office whether "patent examiners have the expertise to review the sort of sophisticated tax strategies . . . that are coming over the transom"). One can certainly question whether tax planning is an "emerging technology" since U.S. income tax planning likely began immediately after the enactment of the U.S. income tax law. "'In America, in 1913, an income tax law was passed and the rich have been devising tax dodging rackets ever since.'" Yablon, *supra* note 1, at 154 (quoting Elliot Paul).

5. The use of the term "loophole" rather than "shelter," "scam," or "dodge" is intentional. A loophole may be surprising, controversial, and unfair, but it effectively reduces the taxpayer's tax liability and complies with existing tax laws. *See* MERRIAM WEBSTER'S COLLEGIATE DICTIONARY 688 (10th ed. 1993) ("[L]oophole[:] . . . a means of escape; especially: an ambiguity or omission in the texts through which the intent of a statute, contract or obligation may be evaded."). For example, the home mortgage interest deduction, I.R.C. § 163(h)(3), is a loophole. *See* Jerald David August, Interview, *Small Business Will Be Hurt by the New Tax Increases, While the Deficit Won't Be Helped*, 79 J. TAX'N. 74 (Aug. 1993) (containing an interview with then-Senator Bob Dole). It can be forcefully argued that the home mortgage interest deduction unfairly favors home owners over renters (especially renters who pay interest on car loans or other personal loans). *See* I.R.C. § 163(h)(1) (West 2007) (prohibiting a tax deduction for "personal interest"). Nevertheless, it is clear that the home mortgage interest deduction is allowed under current law. *Id.* § 163(h)(3).

In contrast, a "scam" or a "dodge" may not comply with current tax laws. Also, a "tax shelter" is technically any arrangement that generates a loss or deduction which can be used to offset other (unrelated) income. *See* David P. Hariton, *Kafka and the Tax Shelter*, 57 TAX L. REV. 1, 12 (2003) ("A tax shelter is a transaction that produces a tax benefit that is used to shelter the tax that otherwise would be imposed on unrelated income."). There may be nothing surprising, controversial, or unfair about a tax shelter. For example, a 1982 American Bar Association ethical opinion indicates that a routine real estate investment may be referred to as a "tax shelter." ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (Revised) (1982), *reprinted in* 68 A.B.A. J. 471 (1982) (noting that because "[a]n opinion by a lawyer analyzing the tax effects of a tax shelter investment is frequently of substantial importance" to investors, there was "a need to issuing patents on tax loopholes.[6] Although the IRS remains ultimately responsible for the administration of the federal tax laws,[7] the Patent Office now will decide whether tax-saving strategies work.[8] Patent examiners are attending special workshops to learn tax law.[9] A taxpayer may be sued for patent infringement, even if the taxpayer was completely unaware of the patent.[10] Before giving tax advice, tax practitioners need to

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articulate ethical standards applicable to a lawyer who issues an opinion which the lawyer knows will be included among the tax shelter offering materials and relied upon by [investors]").

6. As of July 2006, the Patent Office had issued at least forty-eight tax patents, and at least eighty-one tax patent applications were pending. *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. (2006), http://waysandmeans.house.gov/hearings.asp?formmode=view&id=5271 [hereinafter *Patenting of Tax Advice Hearings*] (statement of Ellen Aprill, Associate Dean and Professor of Law, Loyola Law School). Several of these patents and patent applications likely involve methods for processing tax information or preparing tax returns, and therefore do not involve tax-saving strategies. Also, there may be other tax patents and applications that have been filed under a different subclass. *See also infra* note 34 (noting that the Patent Office General Counsel asserts there are forty-one patents and sixty-one published patent applications related to taxes).

7. *See* St. David's Health Care Sys. v. United States, 349 F.3d 232, 239 n.9 (5th Cir. 2003) ("'[IRS] revenue rulings are generally given weight as expressing the studied view of the agency whose duty it is to carry out the statute.'" (quoting Estate of McLendon v. Comm'r, 135 F.3d 1017, 1023 n.10 (5th Cir. 1998))).

8. In determining whether a tax strategy is eligible for patent protection, the Patent Office must decide whether the invention has "utility" under 35 U.S.C.A. § 101 (West 2007). *See infra* Part II.B.2. A tax strategy should have utility if it works—in other words, if it saves taxes. However, neither the IRS nor a court will be barred by a Patent Office determination of "utility" from later concluding that the tax strategy does not save taxes. The Commissioner of the IRS has stated that the granting of a patent on a tax strategy "has no bearing on its legitimacy or illegitimacy under the tax laws, which remain under the jurisdiction of the IRS." *Patenting of Tax Advice Hearings*, *supra* note 6 (statement of Mark Everson, Comm'r, IRS); *see also* STAFF OF J. COMM. ON TAXATION, 109TH CONG., BACKGROUND AND ISSUES RELATING TO THE PATENTING OF TAX ADVICE, 12 (Comm. Print 2006) [hereinafter BACKGROUND AND ISSUES], *available at* http://www.house.gov/jct/x-31-06.pdf ("[T]he IRS may challenge the validity of a taxpayer's position, even though the position is consistent with an issued patent.").

9. *Patenting of Tax Advice Hearings*, *supra* note 6 (statement of Mark Everson, Comm'r, IRS).

10. In 1947, Judge Learned Hand wrote that a taxpayer can arrange her affairs to minimize taxes:

> Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant.

Comm'r v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting); *see also* Rothschild v. United States, 407 F.2d 404, 413 (Ct. Cl. 1969) ("[T]here is nothing wrong with a taxpayer's motive or plan to avoid or lessen his taxes in a legitimate and substantive business research the Patent Office records. Law firms and CPA firms may require that their tax practitioners assign all rights to tax strategies they develop to the firm.[11] Since a patent is basically a seventeen-year monopoly over the market for the invention,[12] the availability of patent protection provides a tremendous economic incentive for tax gurus to find and exploit new loopholes.

At the end of the millennium, the Federal Circuit eliminated the key barrier to inventive tax practitioners seeking patent protection,[13] and since this decision the Patent Office has put out a "Welcome" sign. While testifying before the U.S. Senate Finance Committee on "tax-strategy" patents in 2004, the Commissioner of Patents mentioned no negative consequences from patenting tax strategies, and instead asserted that "there shall be no disparate treatment for different categories of inventions."[14] As

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transaction."); Turner Constr. Co. v. United States, 270 F. Supp. 918, 927 (S.D.N.Y. 1964) ("While there is nothing wrong with a taxpayer attempting to decrease the amount of his taxes or altogether avoid them by means which the law permits, 'the question for determination is whether what was done, apart from the tax motive, *was the thing which the statute intended.*'" (emphasis added) (quoting Gregory v. Helvering, 293 U.S. 465, 469 (1935))); Vinson & Elkins v. Comm'r, 99 T.C. 9, 57 (1992) ("[I]t is a well-settled and basic tenet of Federal tax law that taxpayers are not precluded from structuring their affairs so as to minimize their taxes.").

11. In industries in which employees may develop patentable machines or methods, "[i]t is general practice for firms to require their employees to assign their patents to the employer." ADAM B. JAFFE & JOSH LERNER, INNOVATION AND ITS DISCONTENTS: HOW OUR BROKEN PATENT SYSTEM IS ENDANGERING INNOVATION AND PROGRESS, AND WHAT TO DO ABOUT IT? 30 (2004).

12. A patent frequently is called a "monopoly." *See* Brenner v. Manson, 383 U.S. 519, 534 (1966) (discussing the basic reason for "granting a patent monopoly"); BACKGROUND AND ISSUES, *supra* note 8, at 21 (stating that a patent "grants a monopoly to the holder"). The term "monopoly" is used because the patent grants the holder the exclusive right to prevent others from using the invention for the duration of the patent. BACKGROUND AND ISSUES, *supra* note 8, at 21. For patent applications filed after June 8, 1995, the duration of a patent is twenty years from the date of filing the patent application. 35 U.S.C. § 154(a)(2) (1988), *amended by* Uruguay Round Agreements, Pub. L. No. 103-465, §§ 532-534, 108 Stat. 4809, 4990 (1994). An empirical study concluded that the average length of time needed to obtain a patent after filing a patent application (often referred to as the time of "patent prosecution") is two years and four months. Mark A. Lemley, *An Empirical Study of the Twenty-Year Patent Term*, 22 AIPLA Q.J. 369, 385 (1994) (stating that the average length of a patent prosecution was 864 days). The study was based on 2,081 U.S. utility patents issued on December 27, 1994. *Id.* at 383 (noting also that the study did not include design patents or plant patents). Thus, the average length of patent protection is approximately seventeen years.

13. In *State Street Bank & Trust Co. v. Signature Financial Group, Inc.*, the Federal Circuit eliminated the long-standing rule that a "business method" cannot be patented. 149 F.3d 1368, 1375 (Fed. Cir. 1998). For further discussion of *State Street Bank*, see *infra* notes 47-58 and accompanying text. The Federal Circuit's views on patent law issues are extremely important because the Federal Circuit has nationwide jurisdiction over all patent law cases. 28 U.S.C. § 1295(a) (2000). In other words, every U.S. district court case involving a patent can be appealed to the Federal Circuit.

14. *Bridging the Tax Gap: Hearing Before the S. Comm. on Fin.*, 108th Cong., 194, 197 (2004) [hereinafter *Bridging the Tax Gap*] (statement of Nick Godici, Comm'r of Patents for U.S. Department of Commerce), *available at* http://finance.senate.gov/hearings/95484.pdf. The Patent

a result, it is not surprising that the Patent Office has issued patents for many tax inventions.[15]

The Federal Circuit has stated that neither the courts nor the Patent Office should deny patent protection because an invention violates public policy;[16] instead, only *Congress* can prohibit patent protection for a class of inventions on public policy grounds.[17] This Article analyzes the current status of tax-strategy patents, the authority of Congress to prohibit or restrict tax-strategy patents, and the way in which Congress should respond.

First, this Article will discuss when tax loopholes qualify for patent protection under existing law. Although the Patent Office is issuing tax-strategy patents, the courts have not squarely addressed all the potential problems involved in patenting tax loopholes. For example, certain patentability requirements—e.g., novelty and nonobviousness—will be difficult to apply to tax-strategy inventions. One issued patent has already triggered controversy in the tax-planning world.[18]

Second, this Article argues that Congress has the authority to prohibit or restrict tax-strategy patents notwithstanding the TRIPS Agreement,[19] an international intellectual property treaty.

Third, this Article considers whether Congress *should* prohibit patents on tax strategies. As justification for tax-strategy patents, the Patent Commissioner referred to the traditional utilitarian rationales for issuing patents, namely that new inventions improve the quality of life for all Americans, stimulate economic growth, and make the U.S. economy stronger.[20] While those utilitarian rationales may apply in almost all other

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Office Commissioner also stated, "any 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.* at 203.

15. *See supra* note 6; *infra* note 34.

16. Juicy Whip, Inc. v. Orange Bang, Inc., 185 F.3d 1364, 1368 (Fed. Cir. 1999). For further discussion of *Juicy Whip*, see *infra* notes 94-106 and accompanying text.

17. *Juicy Whip*, 185 F.3d at 1368.

18. *See infra* notes 116-28 and accompanying text (discussing SOGRATs).

19. *See infra* Part III.A (discussing the TRIPS Agreement).

20. *Bridging the Tax Gap*, *supra* note 14, at 195. In defending tax strategy patents, the Patent Office Commissioner stated,

> [The U.S. patent system has] allowed millions of new inventions to be developed and commercialized. This has enhanced the quality of life for all Americans and helped fuel our country's transformation from a small, struggling nation to the most powerful economy in the world. Equally as impressive, the patent system has withstood the test of time. This is powerful evidence of the system's effectiveness in simultaneously promoting the innovation and dissemination of new technologies and the creation of new industries and jobs.

Id.

industries, they fail to support tax-strategy patents because more tax loopholes will not enhance the quality of life for all Americans, stimulate economic growth, or make the U.S. economy stronger.

Also, by granting tax patents, the Patent Office is frustrating the efforts of the Treasury Department, which has adopted regulations to reduce the economic rewards for inventing tax loopholes.

Additionally, the availability of tax-strategy patents will encourage a new breed of "mad-scientist" tax planners,[21] who will pour over every new tax statute, case, or ruling in search of a nascent loophole.[22] Taxpayers, or their advisors, who independently determine that taking certain steps will reduce their taxes may find that they must either pay license fees or face a possible infringement lawsuit.[23] Thus, the "mad-scientist" tax inventor will profit when other taxpayers merely follow the patented procedures that comply with federal tax rules and pay the same amount of tax as similarly situated taxpayers.[24] Other inequities will arise, for example, between taxpayers who pay license fees to the inventor and use the loophole, and taxpayers who decide not to use the loophole because of the license fees. When similarly situated taxpayers are not treated in a similar manner, respect for the tax system erodes, triggering lower levels of voluntary tax compliance.

Other social costs will result from the Patent Office issuing "bad" tax patents and tax patent holders behaving like patent "trolls." Those problems are not unique to tax strategy patents, however, and Congress may reform the patent system generally to reduce those costs.

Fourth, this Article will consider the counterargument: Congress should not take any action regarding tax strategy patents. In other contexts, courts and commentators stress the importance of maintaining a unitary patent system that does not discriminate against classes of inventions. It has been suggested that the patent statutes could become as complex and confusing as the Internal Revenue Code if different patent rules apply to each industry. Also, if Congress, the Treasury Department, or the IRS dislike

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21. It has been suggested that "mad scientists [should] be locked in a corner of the castle while they tinker with [their] new inventions." *See* SKK, Inc. v. Cambridge Sys. Group, Inc., 723 F.2d 553, 560 (7th Cir. 1983).

22. Even without the lure of a patent, tax inventors have been noted for their enthusiasm.

> Driven to build ever more creative raids on the Treasury, they 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 claimed to have found the philosopher's stone by which to perform lead-into-gold alchemy.

Alvin D. Lurie, *How Tax Shelters Evolved: The Road from* Crane *Has Been Paved with Bad Contentions*, 100 J. TAX'N. 274, 275 (2004).

23. 35 U.S.C. § 281 (2000).

24. A fundamental policy of taxation is that similarly situated taxpayers should have the same tax burden. JOEL S. NEWMAN, FEDERAL INCOME TAXATION 25 (3d ed. 2005).

a particular patented loophole, they can simply amend the law, close the loophole, and render the patent worthless.

Fifth, this Article weighs the normative arguments and suggests a nuanced approach. Patent protection is appropriate only when an item otherwise will be produced at sub-optimal levels[25] and there is no compelling need for more loopholes.[26] However, this Article does not recommend prohibiting patents on every tax-related invention. Rather, this Article argues that Congress should prohibit the collection of damages based on tax savings available from using a patented invention.

II. THE PATENTABILITY OF TAX LOOPHOLES UNDER EXISTING LAW

A. *Overview of the Patentability Tests*

A useful process, machine, manufacture, or composition of matter that is new and would not have been obvious to a person of ordinary skill in the art can be patented.[27] Thus, the fundamental standards of patentability can be summarized as follows:

(i) Statutory Subject Matter—The invention must be a "*process*, machine, manufacture, or composition of matter, or any new and useful improvement thereof."[28]

(ii) Utility—The invention must be "useful."[29]

(iii) Novel—The invention must be "new." In evaluating whether the invention is new, printed publications, public use or sales, patents, and patent applications are considered.[30]

(iv) Nonobvious—The invention cannot be patented "if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art."[31]

B. *Applying the Patentability Tests to Tax Strategies Under Existing Law*

In analyzing whether a tax strategy meets the various hurdles for patentability, it is important to note that tax strategies come in many

25. DONALD S. CHISUM ET AL., PRINCIPLES OF PATENT LAW (3d ed. 2004).

26. In fact, more tax loopholes will increase complexity and decrease confidence in the fairness of the U.S. tax system.

27. *See* 35 U.S.C.A. §§ 101-103 (West 2007); *see also* CHISUM ET AL., *supra* note 25, at 728.

28. 35 U.S.C. § 101 (2000) (emphasis added).

29. *Id.*

30. 35 U.S.C.A. § 102(a)-(e) (West 2007).

31. *Id.* § 103(a).

different varieties[32] and that the application of the patentability requirements[33] will depend on the particular facts relating to the invention. Several patents on tax strategies have been issued.[34]

1. Statutory Subject Matter—A Tax Strategy as a "Process"

It is black-letter law that *ideas* are not patentable.[35] In many cases a tax loophole could be described as an idea or a series of ideas. In fact, a *New*

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32. For example, some tax strategies have an economic impact on the parties, while others arguably do not. *See, e.g.*, *infra* notes 268-69 and accompanying text.

33. *See supra* Part II.A.

34. The Patent Office General Counsel testified in July, 2006, that "[w]e have identified 41 issued patents related to tax strategy. Further, 61 published applications, not yet examined, relate to tax strategy." *Patenting of Tax Advice Hearings*, *supra* note 6 (statement of James A. Toupin, General Counsel, U.S. Patent Office). A few of the issued patents include the following:

(i) A strategy to save income taxes (by allowing an investment entity to be taxed as a partnership). *See infra* notes 47-49 and accompanying text.

(ii) A system for funding, analyzing, and managing life insurance policies funded with annuities. U.S. Patent No. 6,950,805 (filed Nov. 9, 2001) (issued Sept. 27, 2005) ("The invention relates to a program that administers a method of funding life insurance policies using annuities that are purchased at least in part using borrowed money, using business and trust structures to reduce and/or eliminate tax.").

(iii) A method and apparatus for modeling and executing a deferred award instrument plan. U.S. Patent No. 6,609,111 (filed Oct. 18, 2000) (issued Aug. 19, 2003) ("The present invention is directed to the administration of various deferred compensation programs that can effectively reduce an individual's income or estate tax.").

(iv) A way to establish and manage grantor-retained annuity trusts funded by nonqualified stock options. U.S. Patent No. 6,567,790 (filed Dec. 1, 1999) (issued May 20, 2003) ("An estate planning method for minimizing transfer tax liability with respect to the transfer of the value of stock options from a holder of stock options to a family member of the holder.").

35. "[L]aws of nature, physical phenomena, and abstract ideas have been held not patentable." Diamond v. Chakrabarty, 447 U.S. 303, 309 (1980); *see also* Diamond v. Diehr, 450 U.S. 175, 185 (1981) ("Excluded from such patent protection are laws of nature, natural phenomena, and abstract ideas."); O'Reilly v. Morse, 56 U.S. (15 How.) 62, 116 (1854) (noting that "[t]he discovery of a principle in natural philosophy or physical science, is not patentable"); Wyeth v. Stone, 30 F. Cas. 723, 727 (C.C. Mass. 1840) (No. 18,107) (noting that "a claim for an art or principle in the abstract" is "utterly unmaintainable in point of law"), *quoted and discussed in* 1 DONALD S. CHISUM, CHISUM ON PATENTS, at §§ 1.03[2], n.28., 1.03[2][a] (2006). "Many judicial decisions recite the maxim that abstract concepts, mathematical algorithms, and scientific principles are not patentable. Under this rule . . . Albert Einstein [could not] patent the special theory of relativity." ROGER E. SCHECHTER & JOHN R. THOMAS, PRINCIPLES OF PATENT LAW 26 (2d ed. 2004). The rationale for not allowing patents on ideas is that such patents might preempt an entire "field of knowledge." BACKGROUND AND ISSUES, *supra* note 8, at 8, 17.

York Times article describes patenting a tax strategy as "locking up an *idea*," and states, "financial planners are patenting their newest *ideas*."[36] Furthermore, congressional hearings on this subject were titled "Issues Relating to the Patenting of Tax *Advice*."[37] One might initially assume that tax loopholes would not be patentable because of the statutory subject matter requirement. Over time, however, the application of the restriction on patenting ideas has greatly narrowed, and the Patent Office is issuing patents on tax loopholes.[38]

a. Basics of the Statutory Subject Matter Requirement

The patent statute provides that an invention can be patented if it fits within one of the following four pigeon-holes: process, machine, manufacture, or composition of matter.[39] The pigeon-hole available for tax strategies is "process."[40]

On the other hand, courts have consistently stated that mere "ideas" cannot be patented.[41] "Einstein['s] . . . law $E = mc^2$, in and of itself, is not patentable."[42] As early as 1908, the principle that ideas cannot be patented was applied to "processes" by application of the "business method" rule, which held that "business methods [were] unpatentable abstract ideas."[43]

36. Rachel Emma Silverman, *The Patented Tax Shelter-Lawyers, Financial Advisors Are Getting Exclusive Rights to Estate-Planning Strategies*, WALL ST. J., June 24, 2004, at D1 (emphasis added). The article also states that "[s]ome pending patents are for *ideas* that border on the controversial." *Id.* (emphasis added).

37. *Patenting of Tax Advice Hearings*, *supra* note 6 (emphasis added).

38. *See supra* notes 6, 34.

39. 35 U.S.C.A. § 101 (West 2007).

40. *See Bridging the Tax Gap*, *supra* note 14, at 2-4. The statute merely defines a "process" as a "process, art or method." 35 U.S.C. § 100(b) (2000).

41. *See supra* note 35.

42. F. Scott Kieff, *Property Rights and Property Rules for Commercializing Inventions*, 85 MINN. L. REV. 697, 745 (2000).

43. State St. Bank & Trust Co. v. Signature Fin. Group, Inc., 149 F.3d 1368, 1377 (Fed. Cir. 1998), *rev'g* 927 F. Supp. 502, 515 (D. Mass. 1996). "The business method exception was centered on the notion that ideas could not be patented, and a method of doing business was merely an idea." 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 (2002).

The best-known of these decisions was probably *Hotel Security Checking Co. v. Lorraine Co.*, which concerned a "'method of and means for cash-registering and account-checking' designed to prevent fraud[] . . . by waiters and cashiers." 160 F. 467, 467 (2d Cir. 1908). "The system employed certain forms that tracked sales and ensured that waiters submitted appropriate funds at the close of business. . . . [T]he court further observed that a 'system of transacting business disconnected from the means of [sic] carrying out the system is not, within the most liberal interpretation of the term, an art' amenable to patenting." SCHECHTER & THOMAS, *supra* note 35, at 50 (quoting *Hotel Sec.*, 160 F. at 469); *see also* Nari Lee, *Patent Eligible Subject Matter Reconfiguration and the Emergence of Proprietarian Norms—The Patent Eligibility of Business Methods*, 45 IDEA 321, 335 (2005) ("[A] method of a business necessarily involves mental processes.").

For the next ninety years, business methods (including tax strategies) basically could not be patented.[44]

However, in 1998, the Federal Circuit eliminated this business method exception[45] and established the test for distinguishing a patentable process

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44. Historically, there were at least three doctrines based on this no-patent-on-ideas principle that prevented a tax strategy from qualifying as patentable subject matter: (i) the "mental steps" doctrine, (ii) the Freeman-Walter-Abele test, and (iii) the business method exception. As discussed in the following paragraphs, the courts have eviscerated all three doctrines.

First, courts developed the mental steps doctrine to deny patent protection when "an essential component of [a process sought to be patented] consists of human mental participation (or possibly even the mechanical equivalent of human mental participation)." 1 CHISUM ON PATENTS, *supra* note 35, § 1.03[6]. "Under the mental steps doctrine, an invention that was principally a matter of human selection, interpretation, or decision-making was not patentable." SCHECHTER & THOMAS, *supra* note 35, at 41. The mental steps doctrine was initially used to deny patent protection to computer-related inventions. *See, e.g.*, Parker v. Flook, 437 U.S. 584 (1978); Gottschalk v. Benson, 409 U.S. 63 (1972); *see also* 1 CHISUM ON PATENTS, *supra* note 35, § 1.03[2][d]. However, the U.S. Supreme Court greatly narrowed the impact of the mental steps doctrine in 1981 when it stated that "an *application* of a law of nature or mathematical formula to a known structure or process may well be deserving of patent protection." Diamond v. Diehr, 450 U.S. 175, 187 (1981). Leading commentators state that "the mental steps doctrine has not played a significant role in patent law at least since the creation of the . . . Federal Circuit in 1982." SCHECHTER & THOMAS, *supra* note 35, at 42.

Second, in the wake of the mental steps doctrine, the relevance of the no-patent-on-ideas concept was maintained through a two-step process known as the Freeman-Walter-Abele test, which would conclude that a process consisting of ideas (specifically mathematical algorithms) would not be patentable unless the ideas had been "applied . . . to physical elements or process steps." *In re* Pardo, 684 F.2d 912, 915 (C.C.P.A. 1982). The Federal Circuit in 1998, however, declared that "the Freeman-Walter-Abele test has little, if any, applicability to determining the presence of statutory subject matter." *State St. Bank*, 149 F.3d at 1374. The Federal Circuit stated that "the mere fact that a claimed invention involves inputting numbers, calculating numbers, outputting numbers, and storing numbers, in and of itself, would not render it nonstatutory subject matter, unless of course, its operation does not produce a 'useful, concrete and tangible result.'" *Id.* (quoting *In re* Alappat, 33 F.3d 1526, 1544 (Fed. Cir. 1994) (en banc)).

Third, and most important for tax strategies, under the "business method" exception, business methods were considered "unpatentable abstract ideas." *See supra* note 35. In discussing the potential impact of granting a patent on a business method, one court stated that in effect the patent gives "a monopoly on [an] idea" and that patenting a system necessary on a certain type of business "is tantamount to a patent on the business itself." *State St. Bank*, 927 F. Supp. 502, 516 (D. Mass. 1996), *rev'd*, 149 F.3d 1368 (Fed. Cir. 1998). The business method exception was eliminated by the Federal Circuit in 1998. *State St. Bank*, 149 F.3d at 1377.

However, some commentators argue that the Patent Office had issued patents on "financial and other business methods . . . at least since 1971." JAFFE & LERNER, *supra* note 11, at 117 (discussing patents issued to Merrill Lynch in 1983 and 1986).

45. Regarding the business method doctrine, the Federal Circuit stated, "We take this opportunity to lay this ill-conceived exception to rest." *State St. Bank*, 149 F.3d at 1375. "[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. The Federal Circuit also stated, "Since the 1952 Patent Act, business methods . . . should have been[] subject to the same legal requirements for patentability as applied

from an unpatentable abstract idea.[46] In *State Street Bank and Trust Co. v. Signature Financial Group, Inc.*,[47] Signature Financial obtained a patent on a data processing system (named "Hub and Spoke") to be used by mutual fund administrators and accounting agents.[48] The data processing system generated "economies of scale in administering investments, coupled with . . . tax advantages."[49] In addressing whether the invention was merely a nonpatentable "abstract idea[]" (like a mathematical algorithm),[50] the Federal Circuit stated that "mathematical algorithms" (such as in a computer program) "standing alone, represent nothing more than abstract ideas until reduced to some type of practical application, i.e., 'a useful, concrete and tangible result.'"[51] The Federal Circuit concluded that Signature Financial's Hub and Spoke data processing system could be a patentable "practical application" rather than a nonpatentable "abstract idea" because "[t]he transformation of data, representing discrete dollar amounts, by a machine through a series of mathematical calculations into a final share price . . . produces '*a useful, concrete and tangible result*'—a final share price momentarily fixed for recording and reporting purposes

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to any other process or method." *Id.* at 1375. The Patent Office General Counsel and many other commentators have pointed to this language to support the view that "the patent system is technology neutral and *there shall be no disparate treatment for different categories of inventions*." *Patenting of Tax Advice Hearings*, *supra* note 6 (statement of James A. Toupin, General Counsel, U.S. Patent Office) (emphasis added); *see also infra* Part IV.C.3. Many commentators have questioned whether business methods should be patentable. *See, e.g.*, Rochelle Cooper Dreyfuss, *Are Business Method Patents Bad for Business?*, 16 SANTA CLARA COMPUTER & HIGH TECH. L.J. 263, 274-75 (2000); Alan L. Durham, *"Useful Arts" in the Information Age*, 1999 BYU L. REV. 1419, 1422-23; John R. Thomas, *The Patenting of the Liberal Professions*, 40 B.C. L. REV. 1139, 1141-42 (1999). However, it can be argued that Congress has actually codified the patentability of business methods by enacting the "prior user" defense in 1999. *See* 35 U.S.C. § 273(b)(1) (2000). The defense is available only with respect to "any subject matter that would otherwise infringe one or more claims for a method." *Id.* The term "method" means "a method of doing or conducting business." *Id.* § 273(a)(3). Presumably, if a business method were not patentable, there would be no need for this defense.

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

47. 149 F.3d 1368 (Fed. Cir. 1998).

48. The data processing system would "facilitate[] a structure whereby mutual funds (Spokes) pool their assets in an investment portfolio (Hub) organized as a partnership." *Id.* at 1370; *see also* JAFFE & LERNER, *supra* note 11, at 118 ("The patented system essentially allowed managers of fund complexes to efficiently adjust the reported value of portfolios, and to allocate expenses, taxes, and other costs. The patented method performs this calculation by multiplying a vector (the price of all the securities that the funds held) by a matrix (the holdings of each security in each fund).").

49. *State St. Bank*, 149 F.3d at 1370.

50. *Id.* at 1372 n.1 (citing *In re* Alappat, 33 F.3d 1526, 1542 (Fed. Cir. 1994) (en banc)) ("[T]he judicially created exceptions, i.e., abstract ideas, laws of nature, etc., should be applicable to all categories of statutory subject matter . . . .").

51. *Id.* at 1373 (quoting *In re Alappat*, 33 F.3d at 1544).

and even accepted and relied upon by regulatory authorities and in subsequent trades."[52]

Thus, as long as a series of steps produces a "useful, concrete, and tangible result," it can be a patentable "process" rather than a non-patentable abstract idea,[53] and the Federal Circuit concluded that the number produced by the invention—the share price—was "useful, concrete and tangible."[54]

The language of the "useful, concrete and tangible result" test poses difficulties.

> The information that is manipulated by the claimed invention at issue in *State Street* may very well be financially *useful*, but in what way is it *concrete* and *tangible*? Isn't it true that as a matter of common discourse and definition, financial information is considered to be *intangible* subject matter? And is financial date [sic] or the transformation of data consistent with the "useful arts" as that term is used in the Constitution?[55]

Since a mere number[56] can satisfy the test, the words "concrete" and "tangible" appear to add no restriction.

Although it has been suggested that a number must be generated by a machine, such as a computer, to be patentable,[57] the language of the *State*

52. *Id.* (emphasis added). "The [Federal Circuit's] ruling did not prove the validity of the patent; they held only that a business method could be patented. Nonetheless, the two parties settled the dispute; State Street agreed to take out a license and dropped its attempt to prove the patent invalid." JAFFE & LERNER, *supra* note 11, at 119.

53. The Federal Circuit adopted this test from a prior opinion, *In re* Alappat, 33 F.3d 1526, in which data was "manipulated" to generate "something useful, concrete and tangible: the display of . . . waveform information on a monitor." CHISUM ET AL., *supra* note 25, at 840. The Federal Circuit also applied the "useful, concrete and tangible result" test in *AT&T Corp. v. Excel Commc'ns, Inc.*, 172 F.3d 1352, 1357 (Fed. Cir. 1999), to conclude that a method that determined whether the parties to a long-distance telephone call used the same long-distance provider was patentable. This information was useful for billing purposes. *See* CHISUM ET AL., *supra* note 25, at 840.

54. *State St. Bank*, 149 F.3d at 1373. A number also satisfied this test in *Excel Commc'ns*, 172 F.3d at 1361.

55. CHISUM ET AL., *supra* note 25, at 839 (emphasis added).

56. In *State St. Bank*, the number was a "share price." 149 F.3d at 1373.

57. As some commentators have observed,

> [N]ew advances in technology had led to a reshaping of business methods. With the advancement of computer technology came new possibilities for automating business methods. The automation of business methods made the apparatuses for carrying them out *more tangible, and therefore, more likely to satisfy the statutory requirements of patentable subject matter.*

Maier et al., *supra* note 43, at 401 (emphasis added).

Street Bank opinion itself suggests that the statutory subject matter requirement has simply been folded into the other statutory requirements. "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*."[58]

Also, the Patent Office has issued guidelines that confirm that a process—including a business method—can be patented even if it does not involve a computer or any other technological device.[59] The Patent Office has requested comments on these guidelines.[60] If the words "concrete" and "tangible" have no meaning and the only relevant part of the test is a "useful . . . result," as a practical matter the rules that ideas or business methods are not patentable has been eliminated.[61] Under the "doctrine of equivalents," patents likely will be infringed whether the alleged infringer performs calculations by hand or with a calculator, computer, or abacus.[62]

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58. *State St. Bank*, 149 F.3d at 1375 (emphasis added); *see also* F. Scott Kieff, *The Case for Registering Patents and the Law and Economics of Present Patent-Obtaining Rules*, 45 B.C. L. REV. 55, 108 (2003).

"The present state of affairs suggests that few, if any, restrictions limit the range of patentable subject matter." SCHECHTER &THOMAS, *supra* note 35, at 24; *see also* Lee, *supra* note 43, at 342 ("[A]s long as it involves some form of activity, any knowledge with some commercial value will not be presumptively barred from patent eligibility."). "[S]ince 1980, case law in the Supreme Court and the Federal Circuit has viewed the statutory list of classes [of patentable subject matter] to be merely representative, and indeed has included 'anything under the sun made by man.'" CHISUM ET AL., *supra* note 25, at 773 (quoting Diamond v. Chakrabafty, 447 U.S. 303, 309 (1980)). In discussing the demise of the statutory subject matter test, some commentators have stated,

> While the omnipresence of computer technology and its significance to the United States economy may have carried the day, 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 35, at 43-44.

59. Interim Guidelines for Examination of Patent Applications for Patent Subject Matter Eligibility, 1300 Off. Gaz. Pat. & Trademark Office 142 (Nov. 22, 2005); *see* BACKGROUND AND ISSUES, *supra* note 8, at 9 ("Although there has been authority that patentable subject matter must involve a machine or other technological application such as a computer, recent Patent Office interim guidelines for examination of patentable subject matter allow the issuance of a patent without such a requirement."); *see also State St. Bank*, 149 F.3d at 1373; Kieff, *supra* note 58, at 108.

60. Request for Comments on Interim Guidelines for Examination of Patent Applications for Patent Subject Matter Eligibility, 71 Fed. Reg. 34,307, 34,307-08 (June 14, 2006).

61. Presumably a pure idea or mathematical equation, such as Einstein's $E=mc^2$, by itself, would still be unpatentable. However, if the pure idea or mathematical equation would be used in a process that produces a useful number, presumably that process would be patentable.

62. While a patent is infringed if the defendant's machine or process "treads on" the claims of the patent, "courts have [also] found infringement when an accused infringing device (or

b. A Tax Loophole as a Patentable Process

In *State Street Bank*, the Federal Circuit stated that a process will constitute statutory subject matter if it provides a "'useful, concrete and tangible result.'"[63] If the courts interpret those words using their plain meaning, many tax strategies may not be patentable. The mental process behind a tax strategy is intangible, and the ability to save money using a tax strategy is also an intangible asset or power. However, a court might focus on the "result" achieved—tax savings—and conclude that saving money is a concrete and tangible result.[64] While the Federal Circuit appears content to allow the statutory subject matter requirement to be folded into the utility requirement[65]—and the Patent Office may be content to issue patents for tax strategies,[66] regardless of whether any machine is used to crunch the numbers—in the future, a court might seriously question whether a tax strategy really produces a "useful, *concrete* and *tangible* result."

Some might argue that the Federal Circuit already concluded that a tax saving strategy is patentable subject matter in *State Street Bank*. For example, in testifying on tax strategy patents, before the Senate Finance Committee the Patent Commissioner relied heavily on *State Street Bank*.[67] Although the patent involved in *State Street Bank* recites that the process provided a tax advantage, the tax advantage was merely an obvious detail.[68] As discussed above, the valuable innovation was the data processing system, which allowed for economies of scale and generated

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process) is an 'equivalent' to that claimed in the patent" under the doctrine of equivalents. *See* CHISUM ET AL., *supra* note 25, at 905.

63. *State St. Bank*, 149 F.3d at 1373 (quoting *In re* Alappat, 33 F.3d 1526, 1544 (Fed. Cir. 1994) (en banc)).

64. *See* CHISUM ET AL., *supra* note 25, at 839 (asking "How Useful, Concrete, and Tangible Is Money?").

65. *See supra* note 58 and accompanying text.

66. *See supra* notes 6, 34 and accompanying text.

67. *Bridging the Tax Gap*, *supra* note 14, at 196-97 ("[T]he significance of *State Street* goes beyond its immediate holding.... [It] clarifies that an invention deemed to be a 'business method' will be treated in the same manner as any other method or process invention. In other words, the patent system is technology neutral and there shall be no disparate treatment for different categories of inventions.").

68. *See* Steven D. Conlon & Vincent M. Aquilino, PRINCIPLES OF FINANCIAL DERIVATIVES: U.S. AND INTERNATIONAL TAXATION, ¶ B2.07[5][a] (2006), *available at* 1999 WL 1336873 ("In the 1980s, mutual funds also began to use trusts as a pooling vehicle for investments of different entities to achieve economies of scale. These arrangements [were] referred to as hub and spoke.... Rulings were obtained from the [IRS] holding that despite their trust status for state law purposes, these trusts are partnerships for federal income tax purposes." (citing I.R.S. Priv. Ltr. Rul. 2005-17-020 (Dec. 20, 2004); I.R.S. Priv. Ltr. Rul. 96-41-007 (June 19, 1996); I.R.S. Priv. Ltr. Rul. 96-19-037 (Feb. 5, 1996)).

the final share price within ninety minutes of the close of the stock markets.[69] As a result, the *State Street Bank* case should not be interpreted as providing a definitive holding that tax strategies always satisfy the statutory subject matter requirement.[70]

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69. State St. Bank & Trust Co. v. Signature Fin. Group, Inc., 149 F.3d 1368, 1371 (Fed. Cir. 1998).

70. In *State St. Bank*, the Federal Circuit held that the "'useful, concrete and tangible result'" was the final share price and did not discuss whether the tax savings would have been a useful, concrete, and tangible result if that test had not already been satisfied. *Id.* at 1373, (quoting *In re* Allapat, 33 F.3d 1526, 1544 (Fed. Cir. 1994) (en banc)). The tax advantage in *State Street Bank* apparently related to the structure of the "Hub." Under Signature Financial's new system, the Hub would be structured as a business trust and taxed as a partnership. U.S. Patent No. 5,193,056 (filed Mar. 11, 1991) (issued Mar. 9, 1993) (as noted under the heading "Background of the Invention"). The use of the business trust taxed as a partnership provided a tax advantage over one mutual fund investing in another mutual fund.

> [I]f one regulated investment company invested in another regulated investment company that had already realized gains during the year but before the investment occurred, the investing company would be taxed on receipt of the year end distribution, on gains that arose before it had invested. This would not occur if instead of investing in one another, each regulated investment company's investment assets were in a partnership and each was allocated its share of gains.

BACKGROUND AND ISSUES, *supra* note 8, at 18 n.79. Furthermore, a business trust normally would be taxed as a corporation, which likely would result in double federal income tax on income earned by the "Hub." Generally, income earned by a corporation (subject to Subchapter C of the Internal Revenue Code) will be taxed at the corporate level, I.R.C. § 11 (2000), and will be taxed again if paid as a dividend to the entity's owners, I.R.C. § 301(c)(3) (West 2007) (stating that certain corporate distributions will be taxed as a "dividend"); I.R.C. § 61(a)(7) (stating that dividends are included in gross income). This double tax would make the arrangement prohibitively expensive. In Signature Financial's system, although the "Hub" would be structured as a business trust under state law, it would be treated as a partnership for tax purposes. U.S. Patent No. 5,193,056 (filed Mar. 11, 1991) (issued Mar. 9, 1993) (as noted under the heading "Background of the Invention"). The "Description" of the patent summarizes the income tax benefit as follows:

> Although the portfolio may legally be a trust or other entity, it is considered to be a partnership for tax purposes. As a partnership, it receives "flow-through" tax treatment and, so, the portfolio does not pay taxes, but rather all economic gain or loss flows through to the portfolio investors. Mutual funds must rely on qualifying for "regulated investment company" (RIC) status under the Internal Revenue Code (the "Code") to avoid taxation. The RIC provisions of the Code generally prevent mutual funds from investing in other types of funds and impede the division of a single mutual fund into multiple mutual funds. These RIC provisions also lead to economic distortions and inequities among shareholders . . . .

'056 Patent (as noted in the fourth paragraph under the heading "Background of the Invention").

Unlike a corporation, a partnership is not subject to income tax, and instead the partnership's income is deemed to flow through to the entity's owners for tax purposes. *See* I.R.C. § 702(a) (West

Even if a business method satisfies the statutory subject matter requirement, other hurdles remain for the inventor seeking a patent.[71] In fact, the court in *State Street Bank* asserts that when a patent application was denied in the past under the business method exception, the patent application could have been denied under one or more of the other statutory patentability requirements.[72]

2. The Utility Requirement—When Will a Tax Strategy Be "Useful"?

A tax loophole will be useful to taxpayers who can lawfully reduce their taxes by exploiting the loophole.[73] But must an invention, including a tax loophole, benefit society *as a whole* to meet the patent law utility requirement?

a. Basics of the Utility Requirement

The utility requirement is both constitutional[74] and statutory.[75] "[T]here is a purpose behind the utility requirement in that it secures a quid pro quo for society. We require the claimed invention to be *operative*; in other words, the invention must function for its *intended purpose*."[76] The

2007); *id.* § 704(a) (stating that partnership income would be allocated among the partners according to the partnership agreement if certain requirements are satisfied). Thus, Signature Financial's structure allowed the arrangement to enjoy the benefits of using an entity structured as a business trust for state law purposes, while avoiding the corporate double tax.

While partnership tax treatment is beneficial to the Hub (because corporate tax treatment would likely make the arrangement prohibitively expensive), the methods for obtaining partnership tax treatment for a business trust were obvious. *See supra* note 68. As the Federal Circuit pointed out, the key to the invention was generating the final share price promptly (within ninety minutes) after the markets closed. *State St. Bank*, 149 F.3d at 1371. The tax advantage was merely an obvious detail in structuring the Hub and Spoke system. It should be noted that the Federal Circuit mentioned the tax advantage only three times, *id.* at 1370-71, and did not specifically address any policy issues unique to the patenting of tax strategies.

71. *State St. Bank*, 149 F.3d at 1375 ("Section 101 specifies that statutory subject matter must also satisfy the other 'conditions and requirements' of Title 35, including novelty, nonobviousness, and adequacy of disclosure and notice.").

72. *Id.* at 1375 n.10 ("All of the 'doing business' cases could have been decided using the clearer concepts of Title 35." (quoting *In re* Schrader, 22 F.3d 290, 298 (Fed. Cir. 1994) (Newman, J., dissenting))).

73. As a practical matter, tax inventors will not seek to patent a tax strategy unless the strategy will be approved by the IRS (or the courts). *See infra* Part IV.B.3.b.iii.

74. U.S. CONST. art. I, § 8, cl. 8 (authorizing the creation of patents "[t]o promote the Progress of Science and *useful* Arts." (emphasis added)).

75. 35 U.S.C. § 101 (2000) ("Whoever invents . . . any new and *useful* process . . . or any new and *useful* improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title." (emphasis added)).

76. Brenner v. Manson, 383 U.S. 519, 534 (1966) ("The basic quid pro quo contemplated by

inventor provides the requisite "quid pro quo" when the invention is "operable to achieve useful results."[77] The utility requirement is closely related to the enablement requirement of 35 U.S.C. § 112.[78]

The Federal Circuit has described the burden of proof in determining whether the claimed invention satisfies the utility and enablement requirements. An assertion of utility in the patent application is presumed correct.[79] The Patent Office then has the burden of challenging the assertion of utility.[80] "Only after the [Patent Office] provides evidence showing that one of ordinary skill in the art would *reasonably doubt* the asserted utility does the burden shift to the applicant to provide rebuttal evidence sufficient to convince such a person of the invention's asserted utility."[81]

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the Constitution and the Congress for granting a patent monopoly is the benefit derived by the public from an invention with substantial utility."). On the other hand, leading authorities argue that "[t]he utility requirement should be low because the requirement itself serves no economic purpose. A useless patent will not be infringed." CHISUM ET AL., *supra* note 25, at 856.

77. *In re* Swartz, 232 F.3d 862, 863 (Fed. Cir. 2000) (per curiam); *see also* Brenner, 383 U.S. at 534 (an invention must have "substantial utility" to be patentable).

78. Under 35 U.S.C. § 112, the inventor must set forth in the specifications of the patent application sufficient information to enable a person skilled in the relevant art to make and use the claimed invention without undue experimentation. 35 U.S.C. § 112. If the claims of a patent application "fail to meet the utility requirement because the invention is inoperative, they also fail to meet the enablement requirement because a person skilled in the art cannot practice the invention." *In re Swartz*, 232 F.3d at 863; *see also In re* Cortright, 165 F.3d 1353, 1356 (Fed. Cir. 1999) ("If the written description fails to illuminate a credible utility, the PTO will make both a § 112, ¶ 1 rejection for failure to teach how to use the invention and a § 101 rejection for lack of utility .... This dual rejection occurs because '[t]he how to use prong of § 112 incorporates as a matter of law the requirement of 35 U.S.C. § 101 that the specification disclose as a matter of fact a practical utility for the invention.'" (citations omitted) (quoting *In re* Ziegler, 992 F.2d 1197, 1200 (Fed Cir. 1993))); *In re* Brana, 51 F.3d 1560, 1564 (Fed. Cir. 1995) ("Obviously, if a claimed invention does not have utility, the specification cannot enable one to use it."); *In re* Watson, 517 F.2d 465, 472 (C.C.P.A. 1975) (finding that the rejection under § 112 regarding enablement stands or falls with the rejection under § 101 regarding utility because they involve the same issues).

79. A specification in the patent application that

> "contains a teaching of the manner and process of making and using the invention in terms which correspond in scope to those used in describing and defining the subject matter sought to be patented *must* be taken as in compliance with the enabling requirement of . . . § 112 *unless* there is reason to doubt the objective truth of the statements contained therein."

In re Brana, 51 F.3d at 1566 (quoting *In re* Marzocchi, 439 F.2d 220, 223 (C.C.P.A. 1971)).

80. *See id.* ("[T]he PTO has the initial burden of challenging a *presumptively* correct assertion of utility in the disclosure." (emphasis added)).

81. *Id.* (emphasis added).

Utility is normally an easy requirement to satisfy.[82] In fact, an invention referred to as the "combination umbrella and lightning rod" was held to satisfy the utility requirement.[83] As discussed below,[84] as a practical matter, tax inventors will not seek to patent a tax strategy unless the strategy will be upheld by the IRS or the courts. As a result, the tax strategies that inventors will seek to patent will save taxes and therefore be useful to taxpayers who can exploit those strategies.

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82. CHISUM ON PATENTS, *supra* note 35, § 4.01 ("[This] requirement is easily met with most mechanical devices and processes, but it is a frequent problem with chemical compounds and processes—particularly pharmaceutical compounds (drugs) . . . .").

83. *Ex parte* Drulard, 223 U.S.P.Q. 364, 366 (1983). The invention issued as U.S. Patent No. 4,447,847 (filed Sept. 28, 1978) (issued May 8, 1984). The court stated "we do not hesitate to say we would not consider using the claimed device for its intended purpose. However, that is insufficient to establish a lack of utility in the sense of [35 U.S.C.] section 101." *Ex parte Drulard*, 223 U.S.P.Q. at 366; *see also* JAFFE & LERNER, *supra* note 11, at 28 (discussing U.S. Patent No. 5,023,850, which "covers a wrist-watch for dogs (or perhaps it is a paw-watch?) that moves at seven times the speed of an ordinary clock"). *In re Watson*, 517 F.2d at 465, demonstrates how a dubious invention can satisfy the utility requirement. An inventor sought a patent for a mouthwash preparation arguing that the composition was useful because it destroyed germs in the mouth. *Id.* at 466. In rejecting various claims in the patent application "for lack of proof of utility," the Patent Examiner cited an FDA Report stating that "[t]here is no convincing evidence that any medicated mouthwash, used as part of a daily hygiene regimen, has therapeutic advantage over . . . water," and a report stating that "[f]or 17 years, medicated mouthwashes have been on the list of unacceptable products maintained by the American Dental Association's Council on Dental Therapeutics." *Id.* at 467-68. In response, the inventor submitted some literature, *id.* at 473, and an affidavit by Morton Pader, Ph.D, regarding a test of twenty-one people indicating that the mouthwash significantly reduced plaque. *Id.* at 470-71. In response to the Pader Affidavit, the Patent Examiner stated that while mouthwash may reduce plaque, it also "destroy[s] the natural bacterial population in the mouth and thus give[s] rise to an overgrowth of monilia which are normally held under control by oral bacteria. This overgrowth of monilia would be expected to lead to death. This is not a statutory *utility*." *Id.* at 471 (emphasis added).

On review, the U.S. Court of Customs and Patent Appeals (CCPA) stated that the FDA report and the American Dental Association report "lend some support to the [Patent] examiner's position." *Id.* at 473. Nevertheless, the CCPA applied a balancing test and concluded that the inventor satisfied the utility test because "[t]he weight of the evidence supports [the inventor's] position that the art does recognize a beneficial effect from germicidal action in a mouthwash." *Id.* at 474. Thus, the CCPA applied the utility test by balancing the evidence regarding the art. In addition, the CCPA in *Watson* notes that while many products or processes

> "would be *more useful* if they were not dangerous or did not have undesirable side effects . . . the fact remains that they are *useful*, useful to doctors, veterinarians and research workers, useful to patients . . . and so are useful within the meaning of 35 U.S.C. § 101. The use of drugs in medicine is frequently a matter of balancing risks to save a life."

Id. at 475 (quoting *In re* Hartop, 311 F.2d 249 (C.C.P.A. 1962)) (emphasis added).

84. *See infra* notes 457-88 and accompanying text.

b. Is an Invention Useful if It Does Not Benefit Society as a Whole?

In 1817, Justice Story listed circumstances when an invention would not be useful and therefore fail the patent law utility requirement.[85] "By useful invention, in the statute, is meant such a one as may be applied to *some beneficial use in society*, in contradistinction to an invention, which is *injurious* to the morals, the health, or the *good order of society*."[86] Under this view, "beneficial" inventions were patentable, and "injurious" inventions were not. Courts denied several patent applications for gambling devices because the use would be injurious to society.[87]

Over time, however, the courts gradually moved away from considering public policy when applying the patent law utility test. In 1903, the Seventh Circuit adopted an approach that significantly reduced the risk that an invention would fail the utility requirement because it was injurious.[88] The Seventh Circuit concluded that to invalidate a patent it is not sufficient to "merely [establish] that the device has been used for pernicious purposes, *but that it is incapable of serving any beneficial end*[.]"[89] Under this approach, the Seventh Circuit stated that when determining patentability, even if the only ways in which the invention had been used were "vicious," the utility requirement would be satisfied if "the instrument was susceptible of good uses, though in fact never put to such before."[90] As an example, the court argued that Colt's revolver was patentable because it could be used for self-defense, even though

> [t]hat instrument of death may have been injurious to morals, in tending to tempt and to promote the gratification of private revenge. It may have been injurious to health, in that it is very liable to accidental discharge, and thereby to cause wounds, and even homicide. It may also have been injurious to good order, especially in the newer parts of the country, because it facilitates and increases private warfare among frontiersmen.[91]

85. Bedford v. Hunt, 3 F. Cas. 37 (D. Mass. 1817) (No. 1,217).

86. *Id.* (emphasis added), *quoted in* CHISUM ET AL., *supra* note 25, at 750.

87. *See, e.g.*, Brewer v. Lichtenstein, 278 F. 512 (7th Cir. 1922); Reliance Novelty Co. v. Dworzek, 80 F. 902, 904 (C.C.N.D. Cal. 1897); Schultze v. Holtz, 82 F. 448, 449 (N.D. Cal. 1897).

88. Fuller v. Berger, 120 F. 274, 279 (7th Cir. 1903).

89. *Id.* at 275 (emphasis added), *quoted with approval in Ex parte* Murphy, 200 U.S.P.Q. 801, 802 (1977).

90. *Id.* at 276.

91. *Id.* at 275 (citation omitted).

In 1977, the Board of Patent Appeals rejected an argument that a gambling device was unpatentable[92] by adopting the Seventh Circuit's approach. In addition, the Board questioned whether the Patent Office should make such determinations regarding public benefits or injuries.[93]

In 1999, the Federal Circuit agreed that the Patent Office should not reject patent applications under the utility test even if the process or product fails to provide a public benefit. In *Juicy Whip, Inc. v. Orange Bang, Inc.*,[94] the invention was designed to deceive the public.[95] The Federal Circuit stated, "The fact that one product can be altered to make it look like another is in itself a specific benefit sufficient to satisfy the statutory requirement of utility."[96] Thus, increasing sales for the merchant apparently makes the invention useful even if the sale is made by deceiving consumers. After *Juicy Whip*, it appears that the utility requirement is satisfied if one party may be helped, even if many other parties are injured[97] (although egregious situations might lead a court to

92. *Murphy*, 200 U.S.P.Q. at 801.

93. The Board stated,

> [The Patent Office] is not the governmental agency charged with the responsibility for determining drug safety [and] we think [the Patent Office] should not be the agency which seeks to enforce a standard of morality . . . by refusing, on the ground of lack of patentable utility, to grant a patent on a game of chance if the requirements of the Patent Act otherwise have been met.

Id. at 803.

94. 185 F.3d 1364 (Fed. Cir. 1999).

95. The device created the illusion to the purchasing public that a beverage was being currently mixed in a display bowl. "The display bowl is said to stimulate impulse buying by providing the consumer with a visual beverage display."*Id.* at 1365. However, in reality the liquid in the display bowl was a specially treated mixture that resisted bacterial growth and could not be safely consumed. *Id.* When a customer ordered a drink after seeing the display bowl, a device located immediately behind the display bowl would mix the ingredients to create the beverage that would be served to the customer. *Id.* Thus, in this "bait and switch" trick, the display bowl was used to induce consumers to order the beverage, but the consumer did not receive a beverage from the display bowl. *Id.* Instead the consumer received a beverage from a post-mix process. *Id.*

96. *Id.* at 1367.

97. The *Juicy Whip* case sparked considerable debate about the role of the Patent Office, particularly in the biotechnology field. *See* Andrew R. Smith, Comment, *Monsters at the Patent Office: The Inconsistent Conclusions of Moral Utility and the Controversy of Human Cloning*, 53 DEPAUL L. REV. 159, 161 (2003). While the *Juicy Whip* case "might have severely weakened the ability of the [Patent Office] to apply the [moral utility] concept to deny patents," the author argues that *Juicy Whip* can be interpreted narrowly so that it precludes the use of the moral utility doctrine only to inventions that "have the capacity to fool some members of the public." *Id. But see* Margo A. Bagley, *Patent First, Ask Questions Later: Morality and Biotechnology in Patent Law*, 45 WM. & MARY L. REV. 469, 469-70 (2003) (noting that the "'moral utility' doctrine served as a type of gatekeeper of patent . . . eligibility . . . . [for] morally controversial subject matter . . . . The gate, however, is currently untended. A combination of the demise of the moral utility doctrine, along

find exceptions).[98] A leading commentator summarizes the state of the law after *Juicy Whip* as follows: "A patent will be withheld only if the invention cannot be used for *any* honest and moral purpose."[99]

More important, the Federal Circuit seized the opportunity to describe the roles of the Patent Office, the courts, and Congress.

> The requirement of "utility" in patent law is not a directive to the Patent . . . Office or the courts to serve as arbiters of . . . trade practices . . . . "Congress never intended that the patent laws should displace the police powers of the States, meaning by that term those powers by which the health, good order, peace and general welfare of the community are *promoted*."
>
> Of course, *Congress* is free to declare particular types of inventions unpatentable for a variety of reasons . . . .[100]

In other words, neither the courts nor the Patent Office will attempt to promote public policy through the application of the patent laws,[101] and

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with expansive judicial interpretations of the scope of patent-eligible subject matter, has resulted in virtually no basis on which the [Patent Office] or courts can deny patent protection to morally controversial, but otherwise patentable, subject matter"); Benjamin D. Enerson, *Protecting Society from Patently Offensive Inventions: The Risk of Reviving the Moral Utility Doctrine*, 89 CORNELL L. REV. 685, 691 (2004) ("The *Juicy Whip* court noted that the rule which would mandate invalidating patents because one can use the item for deceptive or illegal purposes is no longer good law. In fact, most patent attorneys in the United States believe that the 'American view' is that 'morality should . . . have nothing to do with patents.'").

98. For example, if the Artful Dodger developed a superior technique for picking pockets or conducting any other illegal activity, a court might conclude that the activity is not useful even though the invention might benefit a person with criminal intent. *But see Patenting of Tax Advice Hearings*, *supra* note 6 (statement of James A. Toupin, General Counsel, U.S. Patent Office) ("The [Patent Office] has issued patents to inventions that may arguably be illegal . . . and may be considered immoral or offensive by some. . . . [including a patent on] a method of preparing ricin toxin useful for toxicological warfare." (citations omitted)).

99. 1 CHISUM ON PATENTS, *supra* note 35, § 4.03 (emphasis added), *quoted in* Enerson, *supra* note 97, at 692.

100. *Juicy Whip*, 185 F.3d at 1368 (emphasis added) (citations omitted).

101. When testifying before a congressional subcommittee, the Patent Office General Counsel forcefully asserted that the Patent Office makes no effort to promote public policy:

> [T]he [Patent Office] is charged with examining patents following certain patentability criteria as enacted by Congress and interpreted by the courts. . . . [T]he Federal Circuit has stated that there is no clear provision that allows the [Patent Office] to reject an invention solely on the grounds that the invention may be against public policy . . . .
>
> The [Patent Office] has issued patents to inventions that may arguably be *illegal* at least in certain jurisdictions, and may be considered to be *immoral or offensive* by some. For instance, a patent to a method of producing alcoholic

only Congress can promote public policy by declaring particular types of inventions unpatentable.

Regarding the patentability of tax strategies, *Juicy Whip* suggests the following:

(i) A tax strategy may be "useful" under the patent law even if it will work for only a small number of taxpayers.[102]

(ii) The fact that a tax strategy will result in increased taxes for all those who cannot use the tax strategy[103] is irrelevant when evaluating patentability. It is *Congress*—not the Patent Office or the Federal Circuit—which must determine whether tax strategies should be unpatentable on public policy grounds.[104] Since the IRS is charged with the ultimate responsibility for enforcing the tax laws,[105] the Patent Office need not be concerned with the potential impact of taxpayers improperly using a tax strategy to the detriment of the U.S. Government and other taxpayers.[106]

3. When Is a Tax Strategy "Novel"?

As a practical matter, in most cases, the Federal Circuit has eliminated both the statutory subject matter test and the utility test as restrictions on

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> liquids . . . [was] issued during Prohibition, even though the method could be used for then-unlawful purposes. Other examples include a radar detector (. . . issued April 4, 2006) the use of which is unlawful in some jurisdictions; a device for use in cock fights (. . . issued August 16, 2005); . . . a method of euthanizing a mammal (. . . issued March 1, 1994); and a method of preparing ricin toxin useful for toxicological warfare (. . . issued October 23, 1962). In issuing these patents, 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.

Patenting of Tax Advice Hearings, *supra* note 6 (testimony of James A. Toupin, General Counsel, U.S. Patent Office) (emphasis added).

102. *See supra* notes 88-99 and accompanying text.

103. It is often observed that taxes are necessary to finance government and that if one taxpayer pays less, all other taxpayers must pay more. Yablon, *supra* note 1, at 159 ("'The more successfully they escape what they owe, the more the rest of us have to pay.'" (quoting Elliot L. Richardson)).

104. This issue is explored at *infra* Part IV.

105. *See* I.R.C. § 7803(a)(2)(A) (2000).

106. This argument also leads to the conclusion that the Patent Office need not be concerned with product safety, as long as the product can be used beneficially in one or more situations. *See In re* Watson, 517 F.2d 465, 475-76 (C.C.P.A. 1975).

the patentability of business methods. As leading commentators note, since neither test is a "gatekeeper," that leaves only "the messy and difficult novelty and nonobviousness determinations[.]"[107] The application of the novelty requirement[108] has already generated controversy in the tax world.[109]

a. Basics of Novelty

As part of the basic bargain at the foundation of patent law, the applicant must contribute something "new" to the public body of knowledge in exchange for the patent.[110] An invention will not be considered new if (i) the "invention was *known or used* by others in this country," or (ii) the invention was "patented or described in a *printed publication*" anywhere in the world, before the applicant's invention.[111]

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107. CHISUM ET AL., *supra* note 25, at 847.

108. 35 U.S.C.A. § 102 (West 2007).

109. *See infra* notes 116-91 and accompanying text.

110. 1 CHISUM ON PATENTS, *supra* note 35, § 3.01.

111. 35 U.S.C.A. § 102(a) (emphasis added). A potential issue is the extent to which the item must be circulated to be considered a "publication." While books, periodicals, or newspapers of general circulation will be considered publications, trade catalogues, conference papers, and similar items may also constitute publications. *See, e.g.*, MIT v. AB Fortia, 774 F.2d 1104, 1109 (Fed. Cir. 1985) ("[B]etween 50 and 500 persons interested and of ordinary skill in the subject matter were actually told of the existence of the paper and informed of its contents by the oral presentation, and the document itself was actually disseminated without restriction to at least six persons."); Potter Instrument Co. v. Odec Computer Sys., Inc., 499 F.2d 209, 210 n.2 (1st Cir. 1974) ("[L]imited circulation alone, does not disqualify a publication from contributing to the prior art.").

The Federal Circuit has held that a single copy of a dissertation indexed in a library in Freiburg, Germany constitutes a publication that can render claims unpatentable. *In re* Hall, 781 F.2d 897, 900 (Fed. Cir. 1986); *see also* Baxter Diagnostics, Inc. v. AVL Scientific Corp., 924 F. Supp. 994, 1007 (C.D. Cal. 1996) ("A single catalogued doctoral dissertation is sufficiently accessible to one interested in the art to constitute a printed publication."), *modified by* 954 F. Supp. 199, 199 (C.D. Cal. 1996); Ecolochem, Inc. v. S. Cal. Edison Co., 863 F. Supp. 1165, 1174-75 (C.D. Cal. 1994) ("If a publication is kept in a public library or database, the inquiry usually focuses on whether the document has been catalogued and shelved . . . . At least one case suggests that subject matter indexing is not required so long as an alternative research aid, such as an abstract, is available."), *aff'd in part, rev'd in part*, 91 F.3d 169 (Fed. Cir. 1996). *But see* Symbol Techs., Inc. v. Opticon, Inc., 17 U.S.P.Q.2d 1737, 1746 (S.D.N.Y. 1990) (finding that a research paper for a graduate engineering course is not prior art because "[d]efendants made no showing that the paper was widely disseminated so as to be readily available to those skilled in the art"), *aff'd*, 935 F.2d 1569 (Fed. Cir. 1991). However, a "distribution to a limited group with an injunction to secrecy is not a publication." 1 CHISUM ON PATENTS, *supra* note 35, § 3.04[2]. In *Northern Telecom, Inc. v. Datapoint Corp.*, 908 F.2d 931 (Fed. Cir. 1990), four reports on a complex military system were distributed to approximately fifty persons or organizations involved in a project. *Id.* at 936. One of the reports contained the legend, "Reproduction or further dissemination is not authorized . . . not for public release," while the other reports "may have" contained similar notices. *Id.* Also, the reports were housed in a library to which access was restricted to persons authorized by the corporation. *Id.* The Federal Circuit concluded that the reports were not printed publications. *Id.* at 937.

Existing knowledge—whether contained in a patent, printed publication, use, etc.—is frequently referred to as "prior art," and if an item of prior art causes the invention to fail the novelty requirement, the prior art is said to "anticipate" the invention.[112] Prior art will anticipate an invention only if *one* item of prior art contains all the essential elements of the invention[113] and would enable a person with ordinary skill in the art to make or use the invention.[114] In applying the novelty requirement, a fundamental problem is that substantial amounts of prior art might be found only by an expert in the field because "patent examiners are not very good at finding non-patented prior art."[115]

b. Prior Use May Cause Difficulties in Determining the Patentability of Tax Strategies

The issue of novelty has sparked a fierce debate in the tax world concerning a patented tax strategy called the "Stock Option Grantor Retained Annuity Trust," or "SOGRAT."[116] Robert Slane, head of the

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112. 1 CHISUM ON PATENTS, *supra* note 35, § 3.02.

113. *See, e.g.*, Hybritech, Inc. v. Monoclonal Antibodies, Inc., 802 F.2d 1367, 1379 (Fed. Cir. 1986); Jeffrey R. Kuester & Lawrence E. Thompson, *Risks Associated with Restricting Business Method and E-Commerce Patents*, 17 GA. ST. U. L. REV. 657, 666-67 (2001) ("[T]he applicant is generally entitled to a patent unless the examiner can point to a document that discloses all of the elements of the business method."). In contrast, multiple items of prior art may be combined when determining whether an invention satisfies the "nonobvious" standard for patentability. 35 U.S.C.A. § 103(a).

114. Seymour v. Osborne, 78 U.S. (11 Wall) 516, 540 (1870); *see also* Paperless Accounting, Inc. v. Bay Area Rapid Transit Sys., 804 F.2d 659, 665 (Fed. Cir. 1986) ("[A] § 102(b) reference 'must sufficiently describe the claimed invention to have placed the public in possession of it.' . . . '[E]ven if the claimed invention is disclosed in a printed publication, that disclosure will not suffice as prior art if it was not enabling.'" (quoting *In re* Donohue, 766 F.2d 531, 533 (Fed. Cir. 1985))).

115. JAFFE & LERNER, *supra* note 11, at 33.

116. The SOGRAT involves the combination of two routine financial arrangements—a stock option (SO) and a grantor retained annuity trust (GRAT). Stock options are commonly used to provide incentive compensation to employees of publicly-traded companies. *See* LUCIAN BEBCHUCK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 137 (2004) ("Stock options became an increasingly important component of executive compensation during [the 1990's]."). A stock option is a right to buy stock at a fixed price—typically the selling price at the time the option is granted—within a certain period of time. *See* Treas. Reg. § 1.421-1(a)(1) (as amended in 2004) ("[T]he term 'option' means the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, . . . such individual being under no obligation to purchase."). If the stock increases in value, the option will have value; if the stock price drops, the holder loses nothing because the option holder can simply choose not to exercise the option. In effect, a stock option provides the holder with the opportunity to benefit if the stock price increases (assuming the option holder can pay the exercise price), with none of the downside risk.

A GRAT is a common estate tax planning tool. *See* JONATHAN G. BLATTMACHR & GEORGIA

Wealth Transfer Group, an Altamonte Springs, Florida, financial services firm for very wealthy individuals and families,[117] obtained a patent on the SOGRAT.[118] A taxpayer would use this invention by contributing stock

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J. SLADE, 836 ESTATES, GIFTS, AND TRUSTS: PARTIAL INTERESTS—GRATS, GRUTS, QPRTS (SECTION 2702), at A-1 (2006) ("The grantor retained income trust . . . was a traditional estate planning arrangement before Congress [in 1987] set out to restrict its potentially favorable results for intrafamily transfers."). In fact, an entire book has been published on the subject of GRATs (and variations on the GRAT). *Id.*

A GRAT can allow a wealthy family to avoid or reduce gift and estate taxes. Under the federal estate tax, a decedent is taxed on the value of her total property at death. I.R.C. § 2033 (2000) ("The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."); *see generally* I.R.C. §§ 2001-2058 (West 2007) (providing for estate taxes on citizens or residents of the United States). To reduce or avoid estate tax, a parent may attempt to give property to her children or grandchildren during life. An outright gift, however, will trigger gift tax. *Id.* § 2501(a)(1) ("A tax . . . is hereby imposed . . . on the transfer of property by gift during [the] calendar year by any individual . . . ."). The GRAT is a technique to transfer property to younger family members while minimizing gift taxes. Ellen K. Harrison, *A Comparison of Retained Annuities and Sales to Grantor Trusts* (ALI-ABA Course of Study Materials, July 16-18, 1998), WL SD10 ALI-ABA 735, 763 ("In most cases, a GRAT may be structured to produce a minimal gift tax value . . . ."); Lawrence P. Katzenstein, *Transferring Closely-Held Business Interests with GRITs, GRATs and GRUTs* (ALI-ABA Course of Study, Feb. 22-24, 1996), WL CA49 ALI-ABA 49, 59 ("[I]n an actual situation, the annuity would be structured so that there would in fact be little up front gift . . . . The way to reduce the risk is by paying a large enough annuity so that there will be in fact no gift at all up front."). A parent might transfer an asset that is expected to significantly increase in value over time to a trust—a GRAT—and retain the right to receive a stream of income from the trust for a fixed term of years. After the end of the fixed term, the property—the remainder—will pass to the younger generation family members. Blattmachr & Slade, *supra*, at A-1 ("This arrangement usually involves the creation during lifetime of an irrevocable trust by an individual (typically called the grantor) in which the grantor retains the right to income from the trust for a period which would last until the earlier of the expiration of a fixed term of years or the grantor's death. If the grantor survived the term, the property was distributable to . . . the chosen objects of the grantor's bounty (*e.g.*, the grantor's family or friends)."). Gift taxes are minimized because the parent retains an income interest while the children and grandchildren receive only a remainder interest; as long as the parent survives for the term of the GRAT, the property will escape estate tax on the death of the parent. *Id.* at A-37 ("If the grantor survives the fixed term and the property continues to be held in further trust, the trust should be structured so that the property will not be includible in the grantor's gross estate."); *see also* Katzenstein, *supra*, at 70 ("[I]f the grantor dies during the term of the trust . . . the amount includible would [not be] the entire trust but that portion of the trust necessary to generate the annuity."). *But see* Harrison, *supra*, at 763 ("The IRS takes the view that the entire amount of the trust is includible under [I.R.C.] § 2039."). Grantors of GRATs are typically advised to contribute quickly-appreciating assets to a GRAT, such as quickly-appreciating real estate or growth stocks. *See* Harrison, *supra*, at 760, 762 (stating that S-corporation stock, a partnership interest, or a membership interest in an LLC may be contributed to a GRAT). *See* Blattmachr & Slade, *supra*, at A-41 ("[I]f the GRAT grows in excess of the [I.R.C.] § 7520 rate, this excess inures exclusively to the benefit of the remaindermen and will never be subject to transfer tax."); Katzenstein, *supra*, at 54 ("GRATs are effective for appreciating assets . . . .").

117. Silverman, *supra* note 36, at D1.

118. U.S. Patent No. 6,567,790 (filed Dec. 1, 1999) (issued May 20, 2003).

options to a common type of trust used in estate planning called a "Grantor Retained Annuity Trust" or "GRAT."[119] It has been reported that at least fourteen large law firms have paid license fees to the Wealth Transfer Group to use the SOGRAT,[120] that the inventor "ha[s] confronted a large financial institution for pitching a comparable product to its clients,"[121] and that the inventor has hired a firm to review publicly-available SEC filings to detect potential infringers.[122] In early 2006, the inventor sued John W. Rowe, the executive chairman of Aetna, Inc., for alleged infringement of the SOGRAT patent.[123]

In response, other estate planners grumble that contributing stock options to a GRAT is an old trick. The Estate and Gift Tax Committee of the American College of Trust and Estate Counsel (ACTEC) met in October 2004 to discuss tax patents, and "like other ACTEC members, [the head of the Committee said that he had] used similar techniques in his practice for years."[124] Similarly, at a meeting of the American Institute of Certified Public Accountants (AICPA), "[s]peculation was ripe among

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119. "GRATs are a commonly used estate and gift tax planning device." BACKGROUND AND ISSUES, *supra* note 8, at 20. For a description of the use of GRATs, see *supra* note 116.

120. Jacobs, *supra* note 4, at 42. Professors Jaffe and Lerner have specifically cautioned that one should not infer that a patent is valid merely because the patent holder has induced a few players in an industry to pay royalties.

> [T]he [Federal Circuit] has placed much greater emphasis . . . [on] "secondary" considerations [in determining the validity of a patent] . . . . This has led to a variety of problematic—though predictable—consequences. For instance, firms, upon receiving patent awards, frequently will immediately approach their weakest rivals in the industry, demanding that they take out licenses. Firms that do not have the financial resources for a court battle, and whose modest sales may generate only small royalty obligations, can be expected to agree to a license even if they doubt the validity of the patent . . . . [I]f it comes to a legal battle, the patentee can point to the fact that they have already successfully licensed the patent as evidence that it was non-obvious, on the basis of "commercial success."

JAFFE & LERNER, *supra* note 11, at 120-21.

121. Jacobs, *supra* note 4, at 42 ("[The American College of Trust and Estate Counsel (ACTEC)] members report[ed] the matter was resolved amicably and without any financial consequences. [The inventor] declined to comment.").

122. Silverman, *supra* note 36, at D1 ("Mr. Slane . . . track[s] whether executives are transferring large quantities of stock options, a signal that they may be using a technique similar to his.").

123. Wealth Transfer Group v. Rowe, No. 06CV0024 (D. Conn. filed Jan. 6, 2006), *cited in* BACKGROUND AND ISSUES, *supra* note 8, at 20 n.84. An experienced estate planning attorney describing the SOGRAT lawsuit stated that "[t]he lawsuit is in the discovery stage and is anticipated to go to trial in 2007. Because . . . the lawsuit is being prosecuted rigorously, the lawsuit cannot be considered a nuisance lawsuit." *Patenting of Tax Advice Hearings*, *supra* note 6 (testimony of Dennis I. Belcher, Partner, McGuireWoods LLP, Richmond, Va.).

124. Jacobs, *supra* note 4, at 42.

attendees that the tax patents issued to date should have been invalid under the prior art doctrine."[125] At the AICPA meeting, an IRS spokesperson stated, "Even a well-seasoned patent attorney might not be in an appropriate position to determine whether a given tax minimization scheme is an original work."[126]

This debate highlights the difficult issues that can arise when considering whether use by a third party will invalidate a patent. For example, the use must be prior to the date of the patent-holder's invention to invalidate the patent.[127] In this situation, Robert Slane may have invented the SOGRAT in 1998.[128] Thus, while tax practitioners may complain in 2004 that the SOGRAT is an old trick, the real issue is whether contributing stock options to a GRAT was an old trick before Robert Slane's invention.

Further, prior use will invalidate a patent only if it is a public use.[129]

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125. Goulder, *supra* note 3, at 737 ("'The [Patent Office] is getting it wrong,' one [AICPA] member [said].").

126. *Id.* (statement by Josephine M. Bonaffini, the program manager of the IRS Estate and Gift Tax Division).

127. *See* SCHECHTER & THOMAS, *supra* note 35, at 133.

128. The U.S. patent system grants a patent to the "first-to-invent" even if she is not the first to file a patent application. *Id.* at 108 ("[A]t least for the near future, the first-to-invent system appears firmly fixed within the U.S. patent regime."). The first-to-invent maintains her priority to obtain the patent even if she engages in certain activities before filing a patent application.

> The U.S. patent system essentially provides inventors with a one-year period to decide whether patent protection is desirable, and, if so, to prepare an application. This is because specified activities, such as publications or sales, will bar the applicant from obtaining a patent only if they occur before the so-called "critical date," which is the day one year before the application was filed. If, for example, an entrepreneur first discloses an invention by publishing an article in a scientific journal, he knows that he has one year from the publication date in which to file a patent application. If he waits longer than that, his patent will be barred, but if he applies before the one year elapses, the article will not prevent a patent from issuing.

Id. at 405 (citing 35 U.S.C.A. § 102(b) (West 2004)). Since "every other patent-issuing state except the United States" uses a first-to-file system, *id.* at 404, this one-year grace period will not be available if the inventor seeks a foreign patent. However, tax inventors will seek patent protection in the United States only if their inventions will reduce a taxpayer's U.S. tax liability.

129. *See* CHISUM ET AL., *supra* note 25, at 348 ("Public use means use of the product or process 'in its natural and intended way'—even though the invention may in fact be hidden from public view . . . ."). Commentators have stated,

> [T]he courts have held that secret activity comprises a "public use" within the meaning of [35 U.S.C.] § 102(b) when performed by the patent applicant. However, the identical use, when performed by a third party, will not serve as prior art against an unrelated applicant. In so doing, the courts have sought to

Can the tax practitioners prove that their prior use was "public" use? In general, tax advice provided by an attorney is protected by the attorney-client privilege,[130] and tax returns and other tax filings are confidential.[131] However, a public use may be found as long as the product or process was "accessible" to the public or *used in the ordinary course of a trade or business*, and was not part of a "secret use."[132] For example, in *National Research Development Corp. v. Varian Associates, Inc.*,[133] a U.S. district court held that:

> A prior use is public even if there is no effort to show the invention to the public at large even if the invention is completely hidden from view even if viewers of a machine incorporating the invention do not comprehend the invention. There simply is no requirement that the prior user make an effort to make the invention publicly accessible, so long as he or she uses it in the ordinary course of business without efforts to conceal it.[134]

The party asserting a prior public use has the burden to corroborate the oral testimony of use and must prove the prior use by "clear and convincing" evidence.[135] Thus, a tax practitioner attempting to invalidate

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> balance two of the chief policies undergirding § 102, preservation of the public domain and maintenance of the statutory patent term.

SCHECHTER & THOMAS, *supra* note 35, at 90.

130. *See* I.R.C. § 7525(a)(1) (West 2007). The Code provides:

> With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.

Id.

131. *See id.* § 6103(a) ("[Tax] [r]eturns and [tax] return information shall be confidential, and except as authorized by [the Internal Revenue Code] . . . no . . . person . . . who has or had access to returns or return information . . . shall disclose any return or return information . . . .").

132. 1 CHISUM ON PATENTS, *supra* note 35, § 3.05[2].

133. 822 F. Supp. 1121, 1133 (D.N.J. 1993), *aff'd in part, vacated in part*, 17 F.3d 1444 (Fed. Cir. 1994).

134. *Id.* (citations omitted); *see also* CHISUM ET AL., *supra* note 25, at 427. Also, in *Dunlop Holdings, Ltd. v. Ram Golf Corp.*, 524 F.2d 33 (7th Cir. 1975), the court concluded that there was "public use" of certain golf balls even though the public was unaware of the chemical composition of the golf balls. *Id.* at 34-37.

135. Trans-World Mfg. Corp. v. Al Nyman & Sons, Inc., 750 F.2d 1552, 1559 (Fed. Cir. 1984) ("The rule that we apply—that prior use of a device by others must be proved by clear and convincing evidence—is one that a majority of the regional circuits that have considered the

the SOGRAT patent because of prior use would face evidentiary hurdles. Specifically, the tax practitioner would need to show that the stock options were contributed to the GRAT "in the ordinary course of business without efforts to conceal it."[136] Presumably, this requirement would be satisfied as long as several parties were involved and fully informed, the customary steps were taken, and there were no confidentiality (or similar) restrictions imposed on any of the parties involved. For example, the employer issuing the options, all the potential beneficiaries of the GRAT, and all the potential trustees of the GRAT—including any banks or trust companies that could serve as successor trustees—would have been fully informed of the transaction. A more difficult requirement might involve obtaining all the necessary consents to release the information.[137]

4. When Is a Tax Strategy "Nonobvious"?

While critics of the SOGRAT patent have focused on the novelty requirement, the nonobvious test is usually the more difficult hurdle for an inventor seeking to enforce a patent,[138] and its application by the Patent Office and the courts is subject to greater uncertainty.[139]

a. Basics of the Nonobvious Requirement

As part of the basic constitutional bargain, an invention must be "nonobvious" for the inventor to receive a patent.[140] The U.S. Constitution

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question also have applied."). "[T]he phrase 'clear and convincing' means that evidence which produces in your mind a firm belief or conviction as to the matter sought to be established." *Id.* at 1560.

136. *Nat'l Research*, 822 F. Supp. at 1133.

137. *See* I.R.C. § 6103(a) (2006) (regarding the confidentiality of tax information).

138. "The nonobviousness requirement . . . in many ways, is the most significant obstacle that a patent applicant faces." CHISUM ET AL., *supra* note 25, at 532. In fact, the nonobvious requirement arguably includes the novelty requirement because any claims that fail the novelty requirement would also fail the nonobvious requirement. *See* Pro-Mold & Tool Co. v. Great Lakes Plastics, Inc., 75 F.3d 1568, 1573 (Fed. Cir. 1996) ("If one prior art reference describes the claimed invention, it is worse than obvious . . . .").

139. Graham v. John Deere Co. of Kan. City, 383 U.S. 1, 18 (1966) ("What is obvious is not a question upon which there is likely to be uniformity of thought in every given factual context."); Uniroyal, Inc. v. Rudkin-Wiley Corp., 837 F.2d 1044, 1050 (Fed. Cir. 1988) ("The obviousness standard, while easy to expound, is sometimes difficult to apply.").

140. 35 U.S.C.A. § 103(a) (West 2007). The U.S. Supreme Court has traced the nonobvious requirement back to the writings of Thomas Jefferson:

> Jefferson's philosophy on the nature and purpose of the patent monopoly is expressed in a letter to Isaac McPherson (Aug. 1813) . . . . Only inventions and discoveries which furthered human knowledge, and were new and useful, justified the special inducement of a limited private monopoly. Jefferson did not believe

authorizes Congress to "promote the Progress of . . . useful Arts, by securing for limited Times to . . . *Inventors* the exclusive Right to their . . . Discoveries."[141] The nonobvious test determines the degree of innovation necessary to be considered an "inventor" entitled to a patent.[142] Under the statutory nonobvious test,

> A patent may not be obtained . . . if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been *obvious* at the time the invention was made to a *person having ordinary skill in the art* . . . .[143]

The U.S. Supreme Court has stated that the application of the nonobvious test must be based on factual findings—made by the Patent Office or the trial court—in three areas: (i) the scope and content of the prior art; (ii) the differences between the prior art and the claims at issue; and (iii) the level of ordinary skill in the pertinent art.[144] The Federal Circuit has stressed that district courts must make express findings in these three factual areas so that the courts do not wind up in the "tempting but forbidden zone of hindsight."[145]

The first factual inquiry involves the scope and content of the prior art. While the novelty requirement, discussed above, considers whether *one* item of prior art includes all elements of the claimed invention,[146] *multiple* items of prior art can be considered and combined in applying the nonobvious test.[147] Since almost any invention can be viewed as a combination of existing items,[148] a key principle in applying the

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> in granting patents for small details, *obvious* improvements, or frivolous devices. His writings evidence his insistence upon a high level of patentability.

Graham, 383 U.S. at 8-9 (emphasis added).

141. U.S. CONST. art. I, § 8, cl. 8 (emphasis added).

142. In 1850, the U.S. Supreme Court stated that the nonobvious test was not satisfied if "there was an absence of that degree of skill and ingenuity which constitute essential elements of every invention." Hotchkiss v. Greenwood, 52 U.S. (11 How.) 248, 267 (1850).

143. 35 U.S.C.A. § 103(a) (emphasis added).

144. *Graham*, 383 U.S. at 17.

145. Loctite Corp. v. Ultraseal Ltd., 781 F.2d 861, 873 (Fed. Cir. 1985); *see also* Ruiz v. A.B. Chance Co., 234 F.3d 654, 663 (Fed. Cir. 2000) ("Our precedent clearly establishes that the district court must make *Graham* findings before invalidating a patent for obviousness.").

146. *See supra* note 113 and accompanying text.

147. CHISUM ET AL., *supra* note 25, at 532.

148. *See* Safety Car Heating & Lighting Co. v. Gen. Elec. Co., 155 F.2d 937, 939 (2d Cir. 1946) ("Substantially all inventions are from the combination of old elements; what counts is the selection, out of all their possible permutations, of that new combination which will be serviceable."); *see also* JAFFE & LERNER, *supra* note 11, at 46 ("Inventions from different firms . . . build on each other.").

nonobvious test is that one should combine only items of prior art that are analogous,[149] and only if there is "some reason, suggestion, or motivation [that would cause] a person of ordinary skill in the art . . . to combine the references to produce the claimed invention with a reasonable probability of success."[150] Items are analogous when there is some "teaching, suggestion or incentive supporting the combination."[151] For example, in *In re Paulsen*,[152] the Federal Circuit concluded that technology regarding the closure of a piano lid, a kitchen cabinet, and a washing machine cabinet could be considered in determining that the "clam shell" construction used to allow for easy opening and closing of laptop computers was obvious.[153]

The second factual inquiry considers the claims at issue and the prior art. This inquiry is succinctly stated as "whether the subject matter sought to be patented, as a whole, would have been obvious at the time the invention was made to a person having ordinary skill in the art."[154]

The third factual inquiry involves the level of ordinary skill in the pertinent art, or as commentators have posed the matter: "Just Who Is This

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149. 2 CHISUM ON PATENTS, *supra* note 35, § 5.03[1]; *see also In re* Clay, 966 F.2d 656, 658-59 (Fed. Cir. 1992) ("Two criteria have evolved for determining whether prior art is analogous: (1) whether the art is from the same field of endeavor . . . and (2) [if not,] whether the reference still is reasonably pertinent to the particular problem with which the inventor is involved.").

150. SCHECHTER & THOMAS, *supra* note 35, at 159 (discussing Pro-Mold & Tool Co. v. Great Lakes, Plastics, Inc., 75 F.3d 1568 (Fed. Cir. 1996)); *see also In re* Vaeck, 947 F.2d 488, 493 (Fed. Cir. 1991); *In re* Dow Chem. Co., 837 F.2d 469, 473 (Fed. Cir. 1988) ("The consistent criterion for determination of obviousness is whether the prior art would have suggested to one of ordinary skill in the art that this process should be carried out and would have a reasonable likelihood of success, viewed in the light of the prior art.").

151. *In re* Bond, 910 F.2d 831, 834 (Fed. Cir. 1990); *see also* SmithKline Diagnostics, Inc. v. Helena Labs. Corp., 859 F.2d 878, 887 (Fed. Cir. 1988) (the party challenging the validity of the patent "has the burden to show some teaching or suggestion in the references to support their use in the particular claimed combination"); 2 CHISUM ON PATENTS, *supra* note 35, § 5.04[1].

152. 30 F.3d 1475 (Fed. Cir. 1994).

153. *Id.* at 1481. The Federal Circuit stated,

> The problems encountered by the inventors of the . . . patent [at issue] were problems that were not unique to portable computers. They concerned how to connect and secure the computer's display housing to the computer while meeting certain size constraints and functional requirements. The prior art cited by the examiner discloses various means of connecting a cover (or lid) to a device so that the cover is free to swing radially along the connection axis, as well as [a] means of securing the cover in an open or closed position. . . . [G]iven the nature of the problems confronted by the inventors, one of ordinary skill in the art "would have consulted the mechanical arts for housings, hinges, latches, springs, etc."

Id. at 1481-82.

154. CHISUM ET AL., *supra* note 25, at 624. This formulation of the test would allow the phrase "the differences between the subject matter sought to be patented and the prior art are such that" to be deleted from 35 U.S.C. § 103(a).

Person Having Ordinary Skill in the Art?"[155] This person has been referred to as "Mr. Phosita,"[156] and is a hypothetical person[157] who has *complete* knowledge of *all* the existing pertinent art.[158] Mr. Phosita is "presumed to be one who thinks along the line of conventional wisdom in the art and is not one who undertakes to innovate, whether by patient, and often expensive, systematic research or by extraordinary insights."[159]

After conducting these three primary factual inquiries, the Patent Office or the trial court may consider a variety of secondary factors, including "commercial success, long felt but unsolved needs, failure of others,"[160] copying, "unexpected results created by the claimed invention, unexpected properties of the claimed invention, *licenses showing industry respect for the invention*, and skepticism of skilled artisans before the invention."[161] For example, if many competitors in the industry copy or pay substantial license fees to use the claimed invention, this suggests that the claimed invention was not obvious. An advantage of using these secondary considerations is that the decision-maker may avoid relying solely on hindsight.[162] A disadvantage is that developments that are totally irrelevant to the obviousness of the invention can create or influence these secondary considerations. For example, the commercial success of a product may be the result of efficient manufacturing techniques or persuasive advertising.[163] Also, patent holders frequently coerce smaller firms in the market to pay licensing fees—because these smaller firms cannot afford to litigate an infringement lawsuit—and then attempt to use those licenses as evidence of the patent's validity.[164] As a result, the "secondary considerations are just that—secondary. They cannot make a clearly unpatentable product patentable."[165]

155. *Id.* at 620.

156. *Id.* at 620 n.1. "Phosita" is an acronym for "person having ordinary skill in the art."

157. Kimberly-Clark Corp. v. Johnson & Johnson Co., 745 F.2d 1437, 1453 (Fed. Cir. 1984).

158. Custom Accessories, Inc. v. Jeffrey-Allan Indus., Inc., 807 F.2d 955, 962 (Fed. Cir. 1986) ("The person of ordinary skill is a hypothetical person who is presumed to be aware of all the pertinent prior art."); *see also In re* Dow Chem. Co., 837 F.2d 469, 473 (Fed. Cir. 1988) (stating that "the person of ordinary skill is charged with knowledge of the entire body of technological literature").

159. Standard Oil Co. v. Am. Cyanamid Co., 774 F.2d 448, 454 (Fed. Cir. 1985).

160. The U.S. Supreme Court mentioned these three factors in *Graham v. John Deere Co. of Kan. City*, 383 U.S. 1, 17-18 (1966).

161. *In re* Rouffet, 149 F.3d 1350, 1355 (Fed. Cir. 1998) (emphasis added) (citations omitted).

162. *Graham*, 383 U.S. at 36 (noting that the secondary considerations "may also serve to 'guard against slipping into use of hindsight,' and to resist the temptation to read into the prior art the teachings of the invention in issue" (quoting Monroe Auto Equip. Co. v. Heckethorn Mfg. & Supply Co., 332 F.2d 406, 412 (1964))) (citation omitted), *quoted in* CHISUM ET AL., *supra* note 25, at 565.

163. *See* Windsurfing Int'l., Inc. v. AMF, Inc., 782 F.2d 995, 999-1000 (Fed. Cir. 1986).

164. JAFFE & LERNER, *supra* note 11, at 120-21.

165. Arkie Lures, Inc. v. Gene Larew Tackle, Inc., 912 F. Supp. 422, 424 (W.D. Ark. 1996), *rev'd on other grounds*, 119 F.3d 953 (Fed. Cir. 1997).

b. The Nonobvious Requirement and Tax Inventions

While tax practitioners and IRS officials argue that the Patent Office has improperly applied the novelty requirement,[166] the application of the nonobvious requirement likely will be even more difficult for the Patent Office. As a preliminary note, anyone second-guessing a Patent Office determination on nonobviousness has the advantage of hindsight.[167] Reviewing courts have repeatedly warned against the dangers of hindsight.[168] One judge even quoted Milton:

> The invention all admired, and each how he
> To be the inventor missed; so easy it seemed,
> Once found, which yet unfound most would have thought,
> Impossible![169]

Analyzing whether the now-patented SOGRAT invention[170] was obvious demonstrates some of the considerations of applying this statutory requirement to tax patents in general. The independent claim of the SOGRAT patent[171] comprises four items.[172] Other embodiments of the

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166. *See supra* notes 116-28 and accompanying text.

167. *See supra* note 145 and accompanying text.

168. *In re* Dow Chem. Co., 837 F.2d 469, 473 (Fed. Cir. 1988) ("[S]elective hindsight is no more applicable to the design of experiments than it is to the combination of prior art teachings. There must be a reason or suggestion in the art for selecting the procedure used, other than the knowledge learned from the applicant's disclosure."); *see also* Panduit Corp. v. Dennison Mfg. Co., 774 F.2d 1082, 1091-92 (Fed. Cir. 1985) ("It is not appropriate for the Court to engage in hindsight . . . . In deciding the obviousness question, the district court [incorrectly] looked to knowledge taught by the inventor . . . in his patents and in his testimony, and then used that knowledge against its teacher."); W.L. Gore & Assocs. v. Garlock, Inc., 721 F.2d 1540, 1553 (Fed. Cir. 1983) ("It is difficult but necessary that the decisionmaker forget what he or she has been taught at trial about the claimed invention and cast the mind back to the time the invention was made (often as here many years), to occupy the mind of one skilled in the art who is presented only with the references . . . .").

169. Gillette Co. v. S.C. Johnson & Son, Inc., 919 F.2d 720, 726 (Fed. Cir. 1990) (quoting JOHN MILTON, PARADISE LOST, book VI, lines 478-501), *quoted in* CHISUM ET AL., *supra* note 25, at 619.

170. The SOGRAT patent is discussed above. *See supra* notes 116-26 and accompanying text.

171. The "SOGRAT patent" is U.S. Patent 6,567,790 issued May 20, 2003. The patent application was filed on December 1, 1999, with Robert C. Slane as the inventor, and the Wealth Transfer Group, L.L.C. of Altamonte Springs, Florida as the assignee. *See* U.S. Patent No. 6,567,790 (filed Dec. 1, 1999) (issued May 20, 2003).

172. "[T]he legal 'guts' of the patent are its 'claims.' The patent claims are the legal characterization of what is and is not covered by the patent . . . ." JAFFE & LERNER, *supra* note 11, at 28. The four items are,

(i) establishing a GRAT;
(ii) transferring stock options into the GRAT;
(iii) setting the terms of the GRAT, including the duration of the GRAT, the amount of each annuity payment, and the frequency of the annuity

claimed SOGRAT invention involve two additional items.[173]

As discussed above, the application of the nonobvious test requires factual findings in three areas.[174] The first factual inquiry considers the scope and content of the prior art. In the SOGRAT situation, all the individual elements comprising the SOGRAT appear to have been addressed by the prior art.[175]

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payments (e.g., annually, quarterly, monthly, *etc.*); and

(iv) as each annuity payment is made, valuing the stock options and determining the number of stock options to distribute "in kind" to satisfy the obligation to make annuity payments.

See '790 Patent.

173. An "embodiment" is a potential implementation of an invention claimed in a patent. JAFFE & LERNER, *supra* note 11, at 69. The two items are (i) establishing an irrevocable life insurance trust (ILIT), which can acquire life insurance on the grantor's life during the term of the GRAT and receive the remainder of the GRAT assets when the GRAT terminates, and (ii) contributing supplemental assets (such as cash) to the GRAT, in addition to stock options, and using the supplemental assets to make the first annuity payment to the grantor. '790 Patent (located under claims 13, 15, 16, and 17).

174. *See supra* notes 144-59 and accompanying text.

175. Independent claims 1, 13, and 25 of U.S. Patent No. 6,567,790 introduce all the individual elements of the SOGRAT. '790 Patent. These claims introduce six potential elements:

(i) GRAT. The term "GRAT" is an acronym for "Grantor Retained Annuity Trust." '790 Patent (located under claims 1, 13, and 25); *see also* Katzenstein, *supra* note 116, at 51 ("'GRAT'[]: A trust in which the grantor retains the right to a fixed amount paid at least annually for a term of years."). These four words—grantor retained annuity trust—describe the arrangement. A GRAT is a "trust"—it is established by a grantor; it has beneficiaries; it has a trust "res"; its terms are set forth in a trust document; and it is governed by the applicable state law on trusts. A GRAT pays income periodically in the form of an "annuity" (for example, a fixed amount equal to 10% of the initial trust balance payable annually). Katzenstein, *supra* note 116, at 53. Finally, these annuity payments are "retained" by the "grantor" of the trust—in other words, when the trust is established, the grantor retains the right to receive periodic income payments in the form of an annuity. *Id.* The GRAT was a common estate planning tool well before the SOGRAT patent application was filed. *See supra* notes 124-26 and accompanying text.

(ii) Stock Options. '790 Patent (located under claims 1, 13, and 25). As discussed earlier, stock options are commonly used to compensate executives and other employees of publicly-traded corporations. *See supra* note 116.

(iii) Setting the Duration and Other Basic Trust Terms. When establishing any trust, the prior art indicated that setting the duration of the trust, the amount of the income payments, the frequency of the income payments, etc. was common practice in drafting a trust. *See* Harrison, *supra* note 116, at 755-57 ("Term of Annuity: Treas. Reg. § 25.2702-3(d)(3) requires that the instrument fix the term of the annuity based on a term of years, the life of the term holder or for the shorter (but not the longer) of those periods.").

The second factual inquiry considers the patent claims at issue and the prior art.[176] While the prior art discussed each separate element of the independent claim comprising the SOGRAT, a key inquiry is whether the prior art provided a "teaching, suggestion or incentive supporting the combination."[177]

The third factual inquiry is the level of skill in the pertinent art.[178] Regarding the second and third factual inquiries, the Federal Circuit has indicated that no explicit "teaching" in prior printed publications is necessary; instead, a "suggestion" or "incentive" based on the level of skill in the art is sufficient.[179] The Federal Circuit has stated that the suggestion may come "from the nature of a problem to be solved, leading inventors to look to references relating to possible solutions to that problem."[180] In a concurring opinion, one judge phrased the analysis as follows:

(iv) Valuing the Stock Options, and Distributing Stock Options "In Kind" to Satisfy the Obligation to Make Annuity Payments. '790 Patent (located under claims 1, 13, and 25). In 1998, the IRS established guidelines for valuing stock options. Rev. Proc. 98-34, 1998-1 C.B. 983; *see also* Rev. Rul. 98-21, 1998-1 C.B. 975; Mervin M. Wilf, *Gift Tax Planning for Transferable Stock Options* (ALI-ABA Course of Study, Feb. 18, 1999) WL SD51 ALI-ABA 957. Further, the prior art discussed the "in kind" distribution of property from a GRAT to satisfy the periodic obligation to make annuity payments. *See* Harrison, *supra* note 116, at 764 ("An in-kind distribution of appreciated assets limits the ability of the GRAT to shift future appreciation on the distributed asset to the remainder beneficiaries free of gift tax."); *id.* at 765 ("[A] distribution of marketable securities to pay the annuity eliminates the valuation risk.").

(v) Using an irrevocable life insurance trust, or ILIT, to Acquire Life Insurance on the Grantor's Life, and to Serve as the Remainder Beneficiary of the GRAT. '790 Patent (located under claims 13 and 25). The use of an ILIT to acquire life insurance had been discussed in the prior art. *See* DAVID WESTFALL & GEORGE P. MAIR, ESTATE PLANNING LAW AND TAXATION, ¶ 5.06, 5-35-36 (4th ed. 2001) ("One of the basic and most useful tools of estate planning is the irrevocable insurance trust."). Presumably, naming a trust as the remainder beneficiary of a GRAT is obvious.

(vi) Contributing Cash to the GRAT to Make the Initial Annuity Payment. '790 Patent (located under claims 1, 3, 4, 5, 13, 15, 16, 17, and 25). The prior art had discussed loaning cash to the GRAT to allow the GRAT to make annuity payments. *See* Harrison, *supra* note 116, at 777 ("[A] loan to the GRAT to pay the annuity may be necessary."). The prior art had also discussed using cash rather than potentially appreciating property to make the annuity payments. *Id.* at 764 ("An in-kind distribution of appreciated assets limits the ability of the GRAT to shift future appreciation on the distributed assets to the remainder beneficiaries free of gift tax.").

176. *See supra* note 154 and accompanying text.

177. *See supra* note 151 and accompanying text.

178. *See supra* note 155 and accompanying text.

179. *In re* Nilssen, 851 F.2d 1401, 1403 (Fed. Cir. 1988) ("[F]or the purpose of combining references, those references need not explicitly suggest combining teachings, much less specific references.").

180. Pro-Mold & Tool Co. v. Great Lakes Plastics, Inc., 75 F.3d 1568, 1573 (Fed. Cir. 1996).

> [W]e must look at the obviousness issue through the eyes of one of ordinary skill in the art and what one would be presumed to know with that background. . . .
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> . . . While there must be some teaching, reason, suggestion, or motivation to combine existing elements to produce the claimed device, it is not necessary that the cited references or prior art specifically suggest making the combination. Such suggestion or motivation to combine prior art teachings can derive solely from the existence of teaching, which one of ordinary skill in the art would be presumed to know, and the use of that teaching to solve the same or similar problem which it addresses. . . .
>
> In sum, it is off the mark for litigants to argue, as many do, that an invention cannot be held to have been obvious unless a suggestion to combine prior art teachings is found *in* a specific reference.[181]

A person having ordinary skill in the art of estate planning will routinely apply a series of steps in assisting a client. In the language of the Federal Circuit, one could say that an estate planner having ordinary skill in the art would employ this process in "think[ing] along the line of conventional wisdom in the art."[182] First, the estate planner will obtain an inventory of the client's assets to determine the approximate value of each asset and the current ownership of the assets. Second, the estate planner will determine the best way to arrange for the client's assets to pass at death to the individuals (or charities) she chooses.[183] Third, the estate planner will consider the potential estate tax liability that may be triggered upon the client's death.[184] Fourth, if federal estate tax will be triggered by the client's death, the estate planner will obtain detailed information about the client's significant assets and determine whether one or more of a standard group of estate planning devices can be used to significantly reduce the client's taxable estate at death thereby reducing the potential estate tax liability. This standard group of estate planning devices would include lifetime giving, the creation of fractional interests, family limited

181. *In re* Oetiker, 977 F.2d 1443, 1448 (Fed. Cir. 1992) (Nies, J., concurring) (citations omitted) (emphasis added), *quoted in* CHISUM ET AL., *supra* note 25, at 617.

182. Standard Oil Co. v. Am. Cyanamid Co., 774 F.2d 448, 454 (Fed. Cir. 1985).

183. The estate planner will often be concerned with how assets are titled to determine whether probate can be avoided. Methods to avoid probate include joint ownership, transfer-on-death devices, and trusts.

184. The first $2 million of the decedent's taxable property will be exempt from estate tax for decedents dying in 2007 and 2008, and the first $3.5 million will be exempt for decedents dying in 2009. *See* I.R.C. § 2010(c) (West 2007). These exemption amounts are reduced based on the amount of taxable gifts made during lifetime. *Id.* § 2010(b).

partnerships, irrevocable life insurance trusts, sales to grantor trusts,[185] private annuities, self-canceling installment notes, GRATs, and charitable trusts (for the charitably inclined).

Specifically regarding the SOGRAT patent, if stock options represent a significant portion of a client's wealth and the estate will be liable for estate taxes at death, one could argue that a person having ordinary skill in the art of estate planning would review the standard group of estate planning devices that can reduce a taxable estate, including the GRAT.[186] Prior to the filing of the patent application for the SOGRAT, the prior art stated that assets that can significantly appreciate in value, including stock, are excellent candidates for contribution to a GRAT.[187] Accordingly, one could argue that there was a "teaching, suggestion or incentive" to contribute stock options to a GRAT.[188] When a patent application merely changes one element in an existing item of prior art, the test is whether the change "constitutes an inventive leap that would not be obvious to" one skilled in the art.[189] Arguably, a similar situation was considered in the landmark case of *Hotchkiss v. Greenwood*,[190] in which the Supreme Court held that a claimed invention was obvious—and therefore not patentable—because the only difference between an item of prior art and the claimed invention was that the claimed invention used a clay or porcelain doorknob instead of a metal doorknob.[191]

III. CAN CONGRESS PROHIBIT OR RESTRICT PATENTS ON TAX LOOPHOLES?

Before considering whether Congress *should* prohibit or restrict tax strategy patents, it is appropriate to consider whether such an action would

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185. *See* Harrison, *supra* note 116, at 766.

186. While it might be argued that one or more of the *ways* in which the GRAT is used with stock options is nonobvious, the claims and description sections of the patent application appear to negate this argument as the patent application does not suggest applying the invention to any asset other than stock options. *See* U.S. Patent No. 6,567,790 (filed Dec. 1, 1999) (issued May 20, 2003); BACKGROUND AND ISSUES, *supra* note 8, at 20 ("In this patent, the 'invention' is the use of nonqualified stock options to fund the GRAT.").

187. Katzenstein, *supra* note 116, at 54 ("GRATs are effective for appreciating assets.").

188. An experienced estate planner testified before a congressional subcommittee that his firm had contributed many different types of appreciating assets to GRATs, including real estate, marketable securities, stock in private businesses, and thoroughbred race horses. *See Patenting of Tax Advice Hearings*, *supra* note 6, at 7 n.9 (statement of Dennis I. Belcher, Partner, McGuireWoods LLP, Richmond, Va.). He further stated that "[b]ecause nonqualified stock options have desirable features affecting the valuation of the options for transfer tax purposes, the use of nonqualified stock options in a GRAT may be considered rather obvious." *Id.*

189. JAFFE & LERNER, *supra* note 11, at 29 (discussing an example in which the inventor of a new mousetrap substitutes pate de fois gras for the usual bait).

190. 52 U.S. (11 How.) 248 (1850).

191. *Id.* at 266-67 ("[T]here was an absence of that degree of skill and ingenuity which constitute essential elements of every invention.").

violate (i) a treaty that is binding on the United States or (ii) the U.S. Constitution.

A. *Is Congress Required to Grant Patents on Tax Loopholes Because of an International Agreement?*

The United States is a member of the Agreement on Trade Related Aspects of Intellectual Property (the TRIPS Agreement).[192] The TRIPS Agreement provides that "patents shall be available for any *inventions*, whether products or processes, in all fields of *technology*."[193] Thus, the plain language of TRIPS Article 27.1 requires that the U.S. patent system—and the patent system of every other member nation—be technology-neutral with respect to covered "fields of technology."[194] Article 27.1 was a key provision of TRIPS for developed nations.[195]

Commentators disagree whether TRIPS requires patent protection for *business methods in general*. A few commentators have stated that patents must be granted on business methods because of TRIPS Article 27.1,[196]

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192. *See* SCHECHTER & THOMAS, *supra* note 35, at 19-20 ("In order to comply with the TRIPS Agreement, the United States enacted the Uruguay Round Agreements Act in 1995.").

193. Agreement on Trade-Related Aspects of Intellectual Property Rights art. 27, Apr. 15, 1994, 33 I.L.M. 1197, 1208 (1994) (emphasis added).

194. *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 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 . . . .") (referring to comments by Mary Critharis, U.S. Patent Office) (footnote omitted).

195. *See* Carlos Correa, *The GATT Agreement on Trade-Related Aspects of Intellectual Property Rights: New Standards for Patent Protection*, 16 EUR. INTELL. PROP. REV. 327 (1994) (quoted in PAUL GOLDSTEIN, INTERNATIONAL INTELLECTUAL PROPERTY LAW 303 (2001) (citation omitted)). Correa states,

> The issue of patentability and the exclusions thereto has been one of the main areas in the TRIPs negotiations. It was quite evident that the extension of patentability, particularly to pharmaceuticals, in those countries that did not recognize it was a major objective of the proponents of GATT involvement on intellectual property. At the time the Round started almost 50 countries did not confer patent protection to medicine and, in some cases, to other products such as food and beverages.

Id. at 327.

196. *See* Maier et. al., *supra* note 43, at 412-13; *see also* José I. De Santiago, *Patentability of Business Methods in Mexico*, 14-AUT INT'L L. PRACTICUM 126 (2001) ("[P]ursuant to TRIPS . . . patents for business methods may and possibly even should be granted."). Attorneys Kuester and Thomson state,

> The United States has worked hard to convince other countries to adopt intellectual property laws as strong as its own. Pursuant to our international agreements, the United States is limited in its ability to discriminate regarding

with one group stating,

> To either carve out business method patents as . . . unpatentable subject matter, or to limit the rights conferred to inventors of business method patents would run afoul of longstanding principles of both United States and international patent law. These principles [are] cornerstones of United States patent law. . . . [and] have survived the evolution of technology from the days of horse-drawn buggies and candlelight to the days of space exploration and genetic engineering.
>
> . . . .
>
> . . . This is per se discrimination based on technology, and therefore contrary to not only fundamental principles of U.S. patent law, but also to TRIPS.[197]

Other commentators argue that TRIPS Article 27.1 does not require patents on business methods, and apparently many member nations agree. Professor Paul Goldstein argues that business methods are not "inventions" under TRIPS Article 27.1,[198] and points out that "most member states" expressly exclude business methods from the description of patentable subject matter.[199] The United States did not treat business methods as patentable subject matter until 1998,[200] several years after the United States had become a member of the TRIPS Agreement. Thus, if TRIPS requires business method patents, the United States was in

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> patentable subject matter. Imposing additional requirements for patentability of business methods may conflict with Article 27 of [TRIPS], which prohibits discrimination based on the field of technology and imposition of requirements for patentability beyond novelty, non-obviousness, and utility.

Kuester & Thompson, *supra* note 113, at 685.

197. Maier et. al., *supra* note 43, at 412-13.

198. GOLDSTEIN, *supra* note 195, at 309 ("Is the answer that, like mental steps, games or *business methods*, computer programs are not 'inventions'?") (emphasis added); *see also id.* at 307 ("[N]ational legislation may reject the patentability of computer programs or other constituent parts, as currently is the case under European law."). Presumably computer software would be patentable only as a business method.

199. *Id.* at 308 ("The 1973 European Patent Convention . . . Article 52(2) lists among the subject matter that does not constitute inventions, 'schemes, rules and methods for performing mental acts, playing games or *doing business*, and programs for computers.' Comparable provisions appear in the laws of most member states." (emphasis added)). It may be argued that this particular refusal to grant patents to business methods in general can be traced to the historic difficulty in separating non-patentable "ideas" or "mental steps" from patentable "processes." *See supra* notes 35-38 and accompanying text.

200. *See supra* notes 45-58 and accompanying text.

violation until 1998.[201] This demonstrates that any argument to extend patent protection to business methods because of fundamental U.S. patent concepts from the days of the buggy-whip contradicts history: Business methods were not formally recognized as patentable subject matter in the United States until 1998.

Commentators forcefully argue that patent protection is not required because business methods are not "technologies" under TRIPS Article 27.1:

> [The argument that business methods are covered by Article 27.1] is exceptionally weak. Business methods are assuredly *not technologies* within the meaning of the TRIPS Agreement. At the time the United States entered the TRIPS Agreement, 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. With the two other leading patent-granting powers, Europe and Japan, declining to award patents on methods of doing business, the more plausible reasoning is that business methods, like databases, lie without the borders of the TRIPS Agreement.[202]

One leading commentator states that business methods are "commercial activities," rather than a field of technology.[203]

If it is difficult to argue that business methods are a "field of technology," it would be a tremendous stretch to conclude that a tax strategy is a "technology." A reference to the technology department at a company presumably would refer to the research division that develops apparatuses, or perhaps the computer department, but certainly would not refer to the tax department.

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201. While commentators argue that the U.S. Patent Office issued some patents on business methods before 1998, the Federal Circuit did not clearly abolish the business method exception until 1998. JAFFE & LERNER, *supra* note 11, at 117-18.

202. John R. Thomas, *The Responsibility of the Rulemaker: Comparative Approaches to Patent Administration Reform*, 17 BERKELEY TECH. L.J. 727, 754 (2002) (footnotes omitted) (emphasis added); *see also* CHISUM ET AL., *supra* note 25, at 773. "[I]n 2003, the European Parliament, [in a directive,] voted to make software and business methods ineligible for patent protection." CHISUM ET AL., *supra* note 25, at 774. Other commentators have noted that "the United States has not faithfully followed this treaty mandate. Neither has the European Union . . . ." Dan L. Burk & Mark A. Lemley, *Policy Levers in Patent Law*, 89 VA. L. REV. 1575, 1633 (2003) (footnote omitted).

203. *See* Robert P. Merges, *As Many As Six Possible Patents Before Breakfast: Property Rights for Business Concepts and Patent System Reform*, 14 BERKELEY TECH. L.J. 577, 579 n.5 (1999) (A business method patent "describes an essentially commercial (as opposed to technological) activity, typically some way to make or save money"), *quoted in* Lee, *supra* note 43, at 336.

Also, TRIPS Article 27.2 allows members to prohibit patents if necessary to "protect *ordre public*."[204] As discussed below, Congress may conclude that tax loophole patents are contrary to public policy and should be prohibited to promote the policy goals of the U.S. tax system.[205]

B. *Congress's Authority to Prohibit or Restrict Patents in a Particular Field*

The U.S. Constitution grants Congress the authority to "promote the Progress of Science and useful Arts, by securing for limited Times to . . . Inventors the exclusive Right to their . . . Discoveries."[206] Congress has the authority both to set the standards for patentability[207] and to create exceptions to these standards. 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."[208] Also, Congress prohibits the enforcement of a patent on a medical or surgical procedure against a medical practitioner or a related health care entity.[209]

IV. SHOULD CONGRESS PROHIBIT PATENTS ON LOOPHOLES?

A. *Key Arguments for Prohibiting Patents on Loopholes*

Loopholes have been a feature of the U.S. income tax law since its creation.[210] The U.S. tax system is complex,[211] and complexity offers the

204. GOLDSTEIN, *supra* note 195, at 308 ("*Ordre public* means deep-seated public policy . . . .").

205. *See infra* Part IV.A.

206. U.S. CONST. art. I, § 8, cl. 8.

207. *See* 35 U.S.C.A. §§ 101-103 (West 2007) (setting the general standards for patentability).

208. 42 U.S.C. § 2181(a) (2000); *see also* 1 CHISUM ON PATENTS, *supra* note 35, § 1.06[4] n.110 ("[T]he Patent Office generally takes the position that a weapon utilizing special nuclear material or atomic energy is barred by the act regardless of whether or not some nonmilitary utilization may be urged for the 'weapon.'" (quoting the statement of Robert Watson, Comm'r of Patents, Hearings Before the Subcomm. on Legis. of the J. Comm. on Atomic Energy, 86th Cong. 39 (1959)). *But see In re* Brueckner, 623 F.2d 184, 187 (C.C.P.A. 1980) (finding the device patentable because the invention had non-weapon uses, as well as weapon uses).

209. 35 U.S.C. § 287(c) (2000).

210. In an article entitled "Two Cheers for Loopholes," one commentator states,

> Loopholes are as old as taxation itself. In American history, they were a defining characteristic of the tariff, the nation's principal revenue device for more than 120 years . . . .
>
> After World War I, the income tax replaced the tariff as the principal source of federal funds. But the political dynamics of revenue extraction remained the same. Steep marginal rates . . . made loopholes valuable . . . . "The huge inflation following World War I . . . led to irresistible pressure for new tax preferences."

Joseph J. Thorndike, *Two Cheers for Loopholes*, 111 TAX NOTES 311, 371 (2006) (quoting opportunity to find and exploit loopholes. While loopholes seem inevitable, the issue is whether Congress should allow the inventor of a loophole to obtain a seventeen-year monopoly to exploit the loophole (by obtaining a patent). Key arguments for prohibiting patents on loopholes include (i) the utilitarian policy rationales for granting patents are inapplicable to loopholes; (ii) the Treasury Department is reducing the incentive for tax gurus to develop new loopholes;[212] and (iii) allowing private ownership of methods to pay the correct amount of tax will violate the fundamental tax principle that similarly situated taxpayers should be taxed the same[213] and will trigger other inequities.

While these three arguments strongly favor prohibiting tax patent strategies, this Article also addresses three weaker arguments that are being considered in this debate. First, whenever patent protection is initially made available in an industry, experienced practitioners complain that the Patent Office will issue "bad" patents because of its lack of expertise in the area.[214] Second, it can be argued that granting patent protection for tax strategies will trigger many of the problems associated with patent "trolls."[215] While both of these arguments have merit, Congress likely will view these as inherent problems in the patent system that should be addressed by changes in the fundamental patent rules, and therefore Congress will not see them as reasons to enact special legislation prohibiting tax loophole patents. Third, it has been suggested that patents may encourage the development of "evil" tax schemes. As discussed below, because of the transparency of the patent system, there is little or no risk that the availability of patent protection will encourage tax fraud or other evil tax behavior.[216]

1. The Utilitarian Policy Rationales for Granting Patents Do Not Support Tax Loophole Patents

A fundamental assumption of the patent system is that it "provides some incentive that would be present at sub-optimal levels absent the patent system."[217] Otherwise, the patent system would be unnecessary. The

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historian Elliot Brownlee).

211. Yablon, *supra* note 1, at 159 ("'I think there is something desperately wrong with the [tax] system when there is only a small subset of people who understand how it works.'" (quoting Todd McCracken)).

212. *See infra* Part IV.A.2.

213. This principle is frequently referred to as "horizontal equity." NEWMAN, *supra* note 24, at 25.

214. *See infra* Part IV.B.1 (defining and discussing "bad" patents).

215. *See infra* Part IV.B.2 (defining and discussing patent "trolls").

216. *See infra* Part IV.B.3 regarding whether tax planning is evil and whether the availability of patent protection will encourage the development of "evil" tax strategies.

217. CHISUM ET AL., *supra* note 25, at 66.

traditional justifications for granting patents include the following:

(i) Providing an incentive to invent;
(ii) Encouraging disclosure of new inventions, and encouraging additional new inventions inspired by the patented invention;
(iii) Facilitating capital formation and commercialization of new products;
(iv) Creating new jobs; and
(v) Strengthening the U.S. economy and improving the U.S. trade balance.[218]

When testifying before the Senate Finance Committee regarding tax strategy patents, the Patent Commissioner raised almost all of these traditional policy rationales.[219] One may question , however, whether any of these policies are applicable—or should even be pursued—in the field of tax-saving loopholes.

First, offering patents in an industry creates an incentive to inventors by providing them a substantial reward. A patent is basically an economic prize[220] given to the first to invent[221] a process, machine, manufacture, or composition of matter that is useful, novel, and nonobvious.[222] A patent allows the inventor to prevent others from making, using, selling, offering to sell, or importing the claimed invention for the period between the date the patent is issued and the date twenty years after the patent application was filed.[223] If the Patent Office issues the patent three years after the patent application is filed, in effect the patent gives the inventor a seventeen-year "exclusive" on the invention.[224] It is often argued that

218. *See id.* at 66-71. "[T]he relative strength of the various incentive based theories remains a topic of much debate." *Id.* at 66.

219. *Bridging the Tax Gap*, *supra* note 14, at 195.

220. *See* Michael Abramowicz, *Perfecting Patent Prizes*, 56 VAND. L. REV. 115, 119-21 (2003) (discussing the merits of a patent process that operates more like a prize system).

221. 35 U.S.C.A. § 102 (West 2007); *see* SCHECHTER & THOMAS, *supra* note 35, at 404 ("The applicant that was the first to invent . . . is awarded the patent. The U.S. priority rule is described as following the 'first to invent' principle." (footnote omitted)).

222. 35 U.S.C.A. §§ 101-103.

223. *See id.* § 271(a) (describing "infringement of [a] patent"); *id.* § 154(a)(2) (regarding the term of a patent).

224. The time between the filing of a patent application and the issuance of the patent by the Patent Office is referred to as the "patent prosecution." *See* SCHECHTER & THOMAS, *supra* note 35, at 221. Empirical research concludes that the average patent prosecution takes approximately two years and four months. Lemley, *supra* note 12, at 385 (1994) (stating that the average length of a patent prosecution was 864 days). This study was based on 2,081 U.S. utility patents issued on December 27, 1994. *Id.* at 383 (stating that the study did not include design patents or plant patents). Thus, on average, the duration of patent protection from the date the patent issues until the patent expires would be seventeen years and eight months. *See id.* at 385 (calculating the mean

without this economic incentive inventors would not incur the substantial research and development expenses necessary to invent.[225] Even with some non-tax patents, however, it can be argued that the patent system provides too great an incentive.[226] In other words, perhaps the appropriate amount of research and development could be inspired by granting a ten- or fifteen-year monopoly, rather than a seventeen-year monopoly. If the reward is excessively generous to inventors, wasteful "rent-seeking" behavior will be triggered because too many economic players will compete for the prize, and society's resources could be better utilized.[227] Even more fundamental issues arise when considering whether patents are needed to inspire more tax loopholes: Have tax loopholes been produced at suboptimal levels in the past because patents were not available? During the tax shelter boom of the late 1970s and early 1980s,[228] would the U.S. economy have been better off if tax practitioners had been searching for *more* tax loopholes? If a practitioner develops a tax loophole while working for a particular client, is society better off if the practitioner tries to sell the loophole to clients of other tax practitioners?

Second, it is customarily argued that the patent system encourages additional invention as other players in the relevant market study the

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number of days of patent protection to be 6,441—approximately seventeen years and eight months). A study considering only patents that eventually became the subject of litigation concluded that the average patent prosecution time was approximately three years and seven months. John R. Allison & Mark A. Lemley, *Empirical Evidence on the Validity of Litigated Patents*, 26 AIPLA Q.J. 185, 237 (1998) ("The average time in prosecution for litigated patents in the population is 3.6 years, although the lower median (2.7 years) indicates that a few patents spent a great deal of time in prosecution, raising the mean.").

225. SCHECHTER & THOMAS, *supra* note 35, at 9 ("[A]bsent a patent system, inventions could easily be duplicated or exploited by free riders, who would have incurred no cost to develop and perfect the technology involved, and who could thus undersell the original inventor.").

> In general, individuals and businesses acting in their own self-interest will not necessarily invest in education and research to the extent that would be consistent with the best interest of the overall economy . . . . because the benefits from such investments, such as scientific and technological advances, that are made at the expense of one individual or business could be cheaply copied by one's competitors.

BACKGROUND AND ISSUES, *supra* note 8, at 21.

226. *See* CHISUM ET AL., *supra* note 25, at 66 (noting that "the incentive [to invent] may be too great").

227. "Patent incentives may cause too many firms to invest in research and development, resulting in duplicative efforts." *Id.*; *see also id.* at 66 n.161 ("Duplicative efforts to obtain the same value are often cited as an example of so-called rent-seeking behavior.").

228. Grover Hartt, III & Jonathan L. Blacker, *Judicial Application of Issue Preclusion in Tax Litigation: Illusion or Illumination?*, 59 TAX LAW. 205, 231 (2005).

issued patent and attempt to "design around" the new invention.[229] As part of the basic quid pro quo of the patent system, the patent—and in some cases the patent application—will be publicly disclosed.[230] The public disclosure must include a description of the invention that would allow a person of ordinary skill in the industry to practice the invention.[231] This allows other inventors to study the new invention and possibly to develop new and improved inventions. It is often stated that new inventions are made possible by prior developments, or as Sir Isaac Newton eloquently stated, "If I have seen further than others, it is by standing upon the shoulders of giants."[232] Since a patent grants the inventor a seventeen-year monopoly on the patented invention,[233] other players in the market may attempt to create a new invention, allowing them to solve the same problem without infringing the patent. These "second-generation" inventions may be better than the original invention. In other words, if A develops a new mousetrap and captures a huge share of the mousetrap market, A's competitor B may try to build a better mousetrap.[234] This process benefits mousetrap consumers because better products would be available. Regarding tax strategies, one may question whether an incentive to create new tax loopholes—to avoid infringing a patent on an existing

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229. SCHECHTER & THOMAS, *supra* note 35, at 12 ("[T]he Patent Act is thought to stimulate technological advancement by inducing individuals to 'invent around' patented technology.").

230. 35 U.S.C. § 122(b) (2000) (stating that the Patent Office will publish pending applications after eighteen months from the filing date unless the applicant certifies that the invention will not be the subject of a patent application in another country that requires publication of applications eighteen months after filing); *see also* SCHECHTER & THOMAS, *supra* note 35, at 230.

231. 35 U.S.C.A. § 112. The statute requires the following:

> The specification shall contain a written description of the invention, and of the manner and process of making and using it, in such full, clear, concise, and exact terms as to enable any person skilled in the art to which it pertains, or with which it is most nearly connected, to make and use the same, and shall set forth the best mode contemplated by the inventor of carrying out his invention.

Id.

232. Said What?, http://www.saidwhat.co.uk/quotes/famous/sir_issac_newton (last visited Feb. 18, 2007).

233. *See supra* note 12 and accompanying text.

234. Commentators have stated,

> Often, a second-generation product is better than the first: perhaps being cheaper, more effective, or having fewer collateral costs or side effects. Remember the possibility of two drugs usable to cure the same illness but each having distinct side-effects. Patients particularly susceptible to one set of side effects may prefer, if not require, the second, allegedly duplicative drug.

CHISUM ET AL., *supra* note 25, at 71.

tax loophole—benefits society.[235]

Third, the patent system encourages commercialization and capital formation.[236] Without a patent system, an inventor (and her investors) could face a fundamental dilemma. The inventor incurs substantial research and development costs, but once the new product hits the market, potential competitors can copy,[237] manufacture, and sell the new product at a competitive price.[238] Since the competitors did not incur substantial research and development costs, the competitors need not recover those costs. Since the inventor will need to match the competitors' prices, the inventor never recovers her research and development costs.[239] Thus, without a patent system, potential inventors will not have sufficient incentive to invent.[240]

The patent system resolves this fundamental dilemma because a patent grants the inventor a seventeen-year monopoly,[241] which prevents potential competitors from entering the market. As a result, the patent allows the inventor to charge a higher price. Economists refer to this higher price as a "monopoly price."[242] Some inventors may want only to invent, and do not want to manufacture, advertise, sell, or distribute the products

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235. *See infra* Part IV.A.2 (discussing treasury regulations designed to reduce the incentive to create new tax loopholes).

236. *See generally* Kieff, *supra* note 42 (arguing that one of the most important aspects of the current patent system is to encourage commercialization of inventions).

237. The process of disassembling a competitor's product to discover the advances made to develop the new product is called "reverse engineering." Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 476 (1974) ("[R]everse engineering, that is by starting with the known product and working backward to divine the process which aided in its development or manufacture.").

238. *See* SCHECHTER & THOMAS, *supra* note 35, at 9.

239. *See* CHISUM ET AL., *supra* note 25, at 62.

240. JAFFE & LERNER, *supra* note 11, at 8 ("Potential inventors realize that without adequate protection rivals will rapidly copy their discoveries, and that therefore innovation is at best an uncertain route to future profit. As a result, companies would be unlikely to spend significant amounts of money on the Research and Development . . . ."). However, some inventors (such as Thomas Edison) would continue their research and development regardless of the financial reward. *See, e.g.*, CHISUM ET AL., *supra* note 25, at 67 ("[S]ome inventors are simply curious, and will go on inventing absent . . . external incentives . . . .").

241. Whether a patent creates a monopoly depends on the applicable market. If the market considered is the market for the patented product, then the patent creates a monopoly in the market because only the patent-holder can supply that product. On the other hand, if one considers the market for all products that will solve a problem, the patent holder may not necessarily have a monopoly. *See* CHISUM ET AL., *supra* note 25, at 56-62. For example, if inventor X has a patent on the "solar-powered mousetrap," inventor X will have a monopoly in the market for solar-powered mousetraps. On the other hand, if we describe the market as consisting of all those who want to buy a method for removing a mouse from the house, and all those who can supply solutions to that problem, presumably inventor X will not have a monopoly in the market because a buyer can always purchase a cat instead of a solar-powered mousetrap.

242. PAUL A. SAMUELSON, ECONOMICS 503 (10th ed. 1976); *see also* CHISUM ET AL., *supra* note 25, at 61.

produced from the patented invention.[243] These inventors may prefer licensing others to bring the new product to market,[244] and the ability to charge a monopoly price can provide the manufacturers, distributors, sellers, advertisers, and other necessary participants the confidence to invest the necessary capital to bring the new product to market, even though they must pay a license fee to the inventor.[245] A story illustrates this "incentive to commercialize" argument:

> Herbert Spencer . . . invented an excellent invalid chair, and, thinking to give it to the world without recompense to himself, did not patent it. The result was that no manufacturer dared *risk* undertaking its manufacture. Each knew that, *if it succeeded*, competitors would spring up and rob him of most or all of his profits, while, on the other hand, *it might fail*.[246]

Regarding tax strategies, in the absence of patent protection, the inventor's (and the investor's) dilemma is apparent. Once publicly disclosed, many competitors—other tax practitioners—will be able to sell and implement the tax strategy. A member of the public who learns about a new technique likely will consult with her existing tax advisors to implement the technique rather than establish a new relationship with the inventor of the concept. This fundamental dilemma for both the inventor and the investor could be solved by the availability of patent protection. If the inventor obtains a patent, all other tax practitioners and taxpayers desiring to use the technique would be forced to pay, either directly or indirectly, license fees to the inventor to use the tax strategy. A tax inventor who does not wish to market her idea could hire marketers or tax professionals (such as the "Big Five" accounting firms) to publicize the concept and find potential licensees.

While the inventor's (and the investor's) dilemma exists for the creation of a tax strategy, questions can be raised about whether this dilemma needs to be solved and whether a seventeen-year monopoly is the proper response. Should a process that allows taxpayers to pay the correct

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243. *See infra* notes 385-90 and accompanying text (discussing testimony by Dean Kamen, President of the corporation that invented Segway Scooter).

244. "Potentially, one of the most serious problems facing the inventor is the lack of experience and resources necessary to produce, advertise, distribute, and sell large quantities of the invention's commercial embodiment." CHISUM ET AL., *supra* note 25, at 68.

245. A patent cuts the "Gordian Knot of the inventor's paradox . . . and venture capitalists, developers, advertisers, and sellers can all begin to make the necessary investments to ensure that consumers will eventually be offered the invention's commercial embodiment."*Id.* at 69.

246. Giles S. Rich, *The Relation Between Patent Practices and the Anti-Monopoly Laws*, 24 J. PAT. OFF. SOC'Y 85, 179 (1942), *quoted in* CHISUM ET AL., *supra* note 25, at 69; *see also* Kieff, *supra* note 42, at 742.

amount of tax belong to anyone? Should a taxpayer have to pay a monopoly price to use a process that allows the taxpayer to pay the correct amount of tax? If research and development costs are relatively minor, is it necessary to grant the tax inventor a seventeen-year monopoly in the strategy?

Fourth, since the patent system encourages research, development, manufacture, distribution, sale, and advertising of new products, the patent system can create new jobs.[247] However, one can question whether society will be better off with a new breed of tax planner focused on finding and exploiting tax loopholes.[248]

Fifth, since the patent prize encourages research, development, and commercialization of new and better products, it is often stated that patent protection strengthens the U.S. economy and improves the U.S. trade balance.[249] The development of new tax strategies, however, will likely lead Congress, the Treasury Department, and the IRS to increase taxes or otherwise modify rules to compensate for the tax revenue lost to new loopholes.[250] Thus, it seems unlikely that more tax loopholes will strengthen the U.S. economy or improve the U.S. trade balance.

2. Offering Tax Patents Frustrates Regulatory Action Aimed at Diminishing the Economic Incentive to Invent Tax Loopholes

While the Patent Office encourages tax gurus to create more loopholes, the Treasury Department is pushing in the opposite direction. Treasury regulations issued in 2003 discourage the use of trade secret protection and contingent fee arrangements, and regulations proposed in 2006 threaten to effectively prohibit contingent fee arrangements.[251]

Trade secret offers inventors one way to protect their intellectual property. Trade secret protection may be available if one takes reasonable steps to maintain the secrecy of the information.[252] Customary steps

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247. *Bridging the Tax Gap*, *supra* note 14, at 37 (noting that the U.S. patent system creates "new industries and jobs").

248. *See infra* Part IV.A.3.

249. Kieff, *supra* note 42, at 698 n.4 ("Economic research over the past sixty years has amply established a causal link between the development of intellectual property and the growth of our national economy, while also showing that intellectual property is an increasingly critical component of United States capital and foreign trade."); *see also* JAFFE & LERNER, *supra* note 11, at 43 ("[T]he patent system . . . provided the basis for technological progress that propelled the United States into a position of global technological superiority in the nineteenth and twentieth centuries.").

250. *See infra* note 277.

251. Treas. Reg. § 1.6011-4(b)(3)-(4) (2006).

252. ROBERT P. MERGES, PETER S. MENELL & MARK A. LEMLEY, INTELLECTUAL PROPERTY IN THE NEW TECHNOLOGICAL AGE 49 (2d ed. 2000) ("Besides the existence of a trade secret, plaintiffs must show under the Uniform [Trade Secrets] Act that they have taken 'reasonable

include disclosing only to those who "need to know" and requiring those persons to sign confidentiality agreements to prevent widespread distribution of the information.[253] Historically, such confidentiality agreements were typical in tax shelter planning.[254]

The treasury regulations basically provide that a taxpayer who enters into a confidential transaction must file IRS Form 8886 (titled "Reportable Transaction Disclosure Statement") with her tax return[255] and must file a copy of that form with the IRS Office of Tax Shelter Analysis.[256] In effect, the taxpayer must place a red bull's-eye on her tax return that almost guarantees an IRS audit. A confidential transaction is any transaction offered to a taxpayer in which limitations on disclosure are imposed that "protect[] the confidentiality of [the] advisor's tax strategies"[257]—in other words, when the tax advisor attempts to use trade secret protection. The rules apply if the taxpayer pays a minimum fee, which is any amount in excess of $50,000 for an individual, or $250,000 for a corporation.[258] Clearly, potential clients will not want to file IRS Form 8886. In effect, the Treasury Department has made it extremely difficult for a tax practitioner to protect a tax strategy through trade secret law.

Regarding contingent fee arrangements, the 2003 Regulations require a client to file IRS Form 8886 with her tax return—and file a copy with the IRS's Office of Tax Shelter Analysis—if the "fees . . . are contingent on the taxpayer's realization of tax benefits from the transaction."[259] These rules apply to any fee paid "to any person who makes or provides a statement, oral or written, to the taxpayer . . . as to the potential tax consequences that may result from the transaction."[260] In addition, in 2002,

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measures' to protect the secrecy of their idea."); *see generally* Rockwell Graphic Sys., Inc. v. DEV Indus., 925 F.2d 174 (7th Cir. 1991) (examining whether reasonable precautions were taken to protect trade secrets).

253. *See Rockwell Graphic Sys.*, 925 F.2d at 174.

254. *See, e.g.*, Janet Novack & Laura Saunders, *The Hustling of X-Rated Shelters*, FORBES, Dec. 14, 1998, at 198, *available at* http://www.forbes.com/forbes/98/1214/6213198a.htm ("[Price Waterhouse, Coopers, CPAs] also sells . . . 'black box' products. These are 'complex and unique strategies that we do not publicize broadly,' . . . . Each can save a client from tens of millions to hundreds of millions of dollars in tax. [Price, Waterhouse, Coopers, CPAs] markets each black box idea to only a select group of companies . . . .").

255. Treas. Reg. § 1.6011-4(b)(3) (2006) (defining a "confidential transaction"); *id.* § 1.6011-4(d) (requiring that Form 8886 be filed with the tax return).

256. *Id.* § 1.6011-4(e).

257. *Id.* § 1.6011-4(b)(3)(ii).

258. *Id.* §§ 1.6011-4(b)(3)(ii), (iii). "These fees include consideration . . . for services to implement the transaction, for services to document the transaction, and for services to prepare tax returns to the extent that the fees exceed the fees customary for return preparation." *Id.* § 1.6011-4(b)(3)(iv).

259. *Id.* § 1.6011-4(b)(4)(i).

260. *Id.* § 1.6011-4(b)(4)(ii).

the Treasury Department issued regulations governing the practice of "attorneys, [CPAs], enrolled agents, and other persons representing clients before the Internal Revenue Service,"[261] which prohibit charging a "contingent fee for preparing an original tax return or for any advice rendered in connection with a position taken or to be taken on an original tax return."[262] In 2006, the Treasury Department proposed regulations to expand the prohibition on contingent fee arrangements.[263]

These regulations reduce the economic incentive to create tax loopholes. Thus, one government agency—the Treasury Department—is taking action to discourage loopholes. In contrast, the Patent Office (at the direction of the Federal Circuit) is providing a new incentive to create loopholes. Since the Treasury Department is in charge of the sound administration of the U.S. tax system, the Treasury Department's views on sound tax policy should be given greater weight than the view of the Patent Office on this subject.

3. Tax Patents Will Violate Horizontal Equity and Further Deflate Taxpayer Morale

Perhaps the most important principle of tax policy is "horizontal equity"—the notion that similarly situated taxpayers should pay similar taxes.[264] Without horizontal equity, taxpayers will likely view the tax

261. 31 C.F.R. § 10.0 (2006).

262. *Id.* § 10.27(b)(2); *see also* Roger Russell, *Contingent Fee Limits Rile Tax Groups*, ACCOUNTING TODAY, Aug. 7, 2006, http://www.webcpa.com/article.cfm?articleid=21110&pg=acctoday ("Current rules prohibit a practitioner from charging a contingent fee for preparing an original tax return or for any advice rendered in connection with a position taken on an original tax return . . . ."). These regulations are commonly referred to as the "Circular 230 Regulations." Gibbons P.C., New IRS Circular 230 Regulations for Written Tax Advice, http://www.gibbonslaw.com/info/circular230.php (last visited Feb. 18, 2007). The regulations allow a contingent fee to be charged for "advice in connection with an amended tax return . . . but only if the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended tax return . . . will receive substantive review by the [IRS]." 31 C.F.R. § 10.27(b)(3) (2006).

263. Regulations Governing Practice Before the Internal Revenue Service, 71 Fed. Reg. 6421 (proposed Feb. 8, 2006) (to be codified at 31 C.F.R. § 10.27); *see also* 2006-10 I.R.B. 563, *available at* 2006 WLNR 4905385 (noting that the proposed regulations preclude a practitioner "from charging a contingent fee for services rendered in connection with any matter before the [IRS]"). Basically, the proposed regulations would prohibit the use of contingent fees in all situations except in connection with an IRS examination or challenge to an original tax return or an amended tax return, or "in connection with any judicial proceeding arising under the Internal Revenue Code." *Id.* (amending 31 C.F.R. § 10.27(b)(3)).

264. NEWMAN, *supra* note 24, at 25. Other candidates for the most important tax policy objective would include "vertical equity"—whether the income tax burden impacts persons at different income levels appropriately—and "economic impact"—if a tax law is passed to inspire some type of action by taxpayers, whether the law achieves its objective. *Id.* at 25-26.

system as unfair and arbitrary, and taxpayers will be less inclined to comply voluntarily with the tax rules. Voluntary compliance is essential for the proper functioning of the federal income tax system.[265]

A patented tax loophole may leave similarly situated taxpayers in three different situations.[266] The taxpayer who invents the tax loophole and obtains the patent will be able to reduce her taxes without paying any license fees. All other taxpayers who could use the loophole are faced with a choice that will have economic consequences. Some taxpayers may choose to use the loophole and pay license fees to the patent holder to avoid being sued for patent infringement. Other taxpayers will choose not to license the loophole and, out of fear of being sued for patent infringement, will not use the loophole and will pay higher taxes. Thus, similarly situated taxpayers will wind up in three different economic situations as a result of patents on loopholes.

Multiple arguments might be made that the description above overstates the horizontal equity problem. First, one might argue that both the patent-holder and those who license the loophole from the patent-holder will pay the same dollar amount of taxes to the government, and therefore there is "technical" horizontal equity. It seems unlikely, however, that the licensee-taxpayers will appreciate the subtle nuance that they are saving money on their taxes, while paying a portion of that savings to the patent-holder.[267] Rather, the licensee-taxpayers are more likely to grasp the fact that they are paying an unfair amount of money because of the way the government's patent rules work.

Second, one might argue that under the old maxim that a tax strategy will work only if it has "economic substance."[268] Taxpayers who use the loophole are engaging in a meaningful economic activity and the loophole non-users are not. As a result, the argument would be that the two groups are no longer "similarly situated." While the economic substance doctrine is often cited in disputes over tax loopholes, a strong argument can be made that in many cases the level of "economic substance" required for a

265. If the income tax system "functions properly," taxpayers pay the correct amount of tax under the tax laws. In light of the size of the estimated "tax gap" one can question the level of voluntary compliance. *See infra* note 271 and accompanying text.

266. *See Patenting of Tax Advice Hearings*, *supra* note 6 (statement of Dennis I. Belcher, Partner, McGuireWoods LLP, Richmond, Va.) ("If there is a business method patent in a particular area of business, a citizen has the choice to either pay for the right to use the technique, to engage in that business activity in a different way, or not to engage in that business activity at all.").

267. If treasury regulations prohibit the use of contingent fees for tax planning, setting license fees for tax loopholes may become very challenging.

268. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3.3 (3d ed. 1999) ("[T]he substance-over-form principle has been called 'the cornerstone of sound taxation.' . . . Unfortunately, it is almost impossible to distill useful generalizations from the welter of substance-over-form cases.").

transaction to be respected for tax purposes is extremely minimal, and likely non-existent in the opinion of the average taxpayer.[269] Thus, in many cases, the loophole users and the loophole non-users will still be similarly situated.

Third, one might argue that the patent-holder is no longer similarly situated because she put forth the effort to invent the loophole. This argument fails to consider that patent rights are provided exclusively to the first-to-invent. The unlucky person who puts forth the same level of effort as the patent winner but just happens to end up being a subsequent inventor of the loophole receives no prize at all from the patent system and can be sued as a patent infringer.[270] In contrast to other industries, this "second-inventor" problem may be particularly severe because many tax loopholes will be generated by changes in the law, such as the passage of a new tax statute, and the winner of the patent will simply be the first one to uncover the loophole. There may be many, many tax practitioners right on the heels of the first-to-invent.

A key danger of violating the horizontal equity principle is erosion of taxpayer confidence in the system. If the tax rules are unfair and arbitrary, it seems appropriate to "game the rules." Also, if the rules are unreasonably complex, more taxpayers may simply not even try to comply. These are important concerns for the U.S. income tax system. Government officials have estimated the "tax gap"—the difference between taxes owed and taxes paid—at between $312 billion and $362 billion.[271] Additionally, recent reports indicate that offshore transactions to avoid U.S. income taxes are out of control.[272] In this environment, one can question whether the patent laws should introduce greater horizontal inequity into the tax system.

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269. "There are times . . . when form alone determines tax consequences . . . . The appeal to substance is sometimes deplored as more confusing than helpful, and the words 'form' and 'substance' have been castigated by Judge Learned Hand as 'vague . . . anodynes for the pains of reasoning.'" *Id.* (quoting Comm'r v. Sansome, 60 F.2d 931, 933 (2d Cir. 1932)); *see also* Cottage Sav. Ass'n. v. Comm'r, 449 U.S. 554 (1991) (involving a "swap" of a bundle of mortgages with almost identical economic characteristics in the aggregate); *infra* notes 426-30 and accompanying text (regarding the *Riggs* case).

270. Kieff, *supra* note 42, at 736 ("Neither innocent copying nor independent origination of a patented invention provides a defense to patent infringement."); *see also* 35 U.S.C.A. § 102(g) (West 2007) (providing that only one person can receive a patent). As discussed below, although the prior user defense can protect certain business method users from being sued for infringement, that defense likely will have very limited application in the tax industry. *See infra* notes 325-27 and accompanying text.

271. Martin A. Sullivan, *Closing the Tax Gap: One Step Forward, Two Back*, 110 TAX NOTES 691, 691 (2006) ("The latest estimate, for 2001, puts the sum total of tax cheating and mistakes in a range from $257 billion to $298 billion. Adjusting those figures to 2007 levels shifts the gap to the range of $312 billion to $362 billion.").

272. *See* Glenn R. Simpson, *Asset Management: How Tax Shelters Brought Trouble to Billionaire Clan*, WALL ST. J., July 31, 2006, at A1 (discussing offshore transactions examined by the U.S. Senate Permanent Subcommittee on Investigations).

B. *Other Arguments That May Be Made for Prohibiting Tax Strategy Patents*

1. Many "Bad" Patents May Be Issued

a. Defining a Bad Patent

When an invention does not satisfy the requirements for patentability, but the Patent Office nevertheless issues a patent, the patent can be described as "bad."[273] A bad patent may fail to satisfy one or more statutory requirements. Examples of bad tax patents include the following:

(i) A tax strategy that does not work;
(ii) A tax strategy that is not novel; and
(iii) A tax strategy that is obvious.

Bad tax patents may trigger different social costs and may require different approaches to reduce or eliminate those costs.

b. The Social Costs of a Patent on a Tax Strategy That Does Not Work

A determination by the Patent Office should not impact the IRS's (or a court's) evaluation of a tax strategy.[274] Thus, after the Patent Office issues a patent, the IRS could rule that the tax strategy does not work,[275] and the IRS determination may be upheld in court. In this situation, at least five types of costs could be incurred.

First, if the inventor marketed and licensed the invention to taxpayers and their advisors, the inventor likely will lose time and money in settling disputes with her disgruntled licensees after the IRS rules that the tax strategy does not work.[276]

Second, taxpayers may license and use the tax strategy. If the IRS audits a taxpayer and spots the issue, the taxpayer-licensee will have incurred the license fees, enjoyed no tax savings, and lost time and money battling the IRS.

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273. Lemley, *supra* note 2, at 1495 (noting that "the [Patent Office] should do a more careful job of reviewing patent applications and should weed out more 'bad' patents").

274. *See supra* note 8.

275. The IRS can issue a revenue ruling if it wishes to publicize its position on a tax issue. *See* MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 3.03[1] (2d ed. 2004) ("The [IRS] National Office issues revenue rulings . . . for the purpose of informing and providing guidance on substantive tax issues to taxpayers . . . .").

276. The inventor might avoid these costs by seeking and obtaining a favorable private letter ruling from the IRS prior to marketing and licensing the invention. However, there are many situations when the IRS will not rule in advance. For example, the IRS will not issue an advance ruling on a hypothetical situation or on a question of fact. *See* Rev. Proc. 2006-1, 2006-1 I.R.B. 1.

Third, the IRS may fail to audit some taxpayers who use the patented process, or the IRS may fail to spot the issue on some of the tax returns they audit. In these cases the taxpayer-licensees will pay less than their appropriate share of taxes, causing other taxpayers to pay more than their fair share.[277]

Fourth, the IRS will incur additional costs in auditing the tax returns that exclude income or claim deductions based on the patented tax strategy. Taxpayers will bear the increased cost of IRS enforcement.[278]

Fifth, patents on tax strategies that do not work may further undermine confidence in the U.S. tax system.[279] Although courts have clearly stated that the issuance of a patent is not a guarantee to the general public that an invention works in all cases,[280] the U.S. tax system already has a reputation for complexity[281] and unfairness.[282] If the Patent Office determines that a tax strategy works, and the IRS later concludes that the tax strategy does not work, the disagreement will further highlight the difficulty of complying with existing U.S. tax laws.

While the risk that the Patent Office will issue patents on tax strategies that do not work could be reduced if the IRS (or the courts) reviewed the patent application, such an intrusion into the patent procedure is unlikely to be implemented unless major problems are publicized in the future.[283]

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277. Yablon, *supra* note 1, at 160 ("'To the extent that some people are dishonest or careless in their dealings with the government, the majority is forced to carry a heavier tax burden.'" (quoting President John F. Kennedy)).

278. Consider whether audited taxpayers should be charged an extra fee to cover the cost of the audit when the IRS prevails.

279. Since the U.S. tax system depends on self-assessment, compliance with the tax laws may be directly related to taxpayers' confidence in the system. For example, presumably people who believe that everyone cheats on their taxes will be more likely to cheat.

280. *See, e.g., In re* Watson, 517 F.2d 465, 465 (C.C.P.A. 1975); *see also supra* note 83.

281. BITTKER & LOKKEN, *supra* note 268, ¶ 3.8 ("One of the most obvious features of the federal income tax is its complexity. Although complaints about the complexity are nearly universal and analyses of the problem are legion, new layers of complexity are added by nearly every major revenue bill.") (footnote omitted).

282. *Id.* ("There often is a tension between the goals of simplicity and fairness. Simple statues may not be fair because they lump together taxpayers who, in fairness, should be treated differently.").

283. In a congressional hearing, the IRS Commissioner emphasized that the IRS does not intend to directly participate in the patent-granting process:

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

Patenting of Tax Advice Hearings, *supra* note 6 (testimony of Mark Everson, Comm'r, IRS).

If patent applications on tax strategies are promptly publicized,[284] the duration of these social costs can be limited. The IRS could quickly advise the public that the tax strategy does not work, which should promptly stop the use of the strategy and begin the process of ending the social costs. Alternatively, the IRS can audit the taxpayers who use the strategy and attempt to litigate the strategy in court. In addition, Congress could pass legislation to clarify that the strategy does not work.

c. The Social Costs of a Patent on a Tax Strategy That Is Obvious or That Is Not Novel

In these situations, the patented tax strategy will not lead taxpayers to file incorrect tax returns, and as a result, likely will not impact all taxpayers generally.[285] Instead, the social costs will be restricted to the inventor, to those who obtain a license from the inventor, and to those who refrain from using the strategy for fear of being sued for infringing the patent. If the inventor obtains a patent on the tax strategy, the patent will have a presumption of validity,[286] and presumably, the inventor will be confident in charging substantial license fees to customers.[287] If the patent is later held invalid, the remedies available to the customers will depend on the terms of the license.[288] In any event, the inventor and the licensees will spend time and money establishing and unwinding their relationships. Additionally, other taxpayers who elected not to obtain a license and who refrained from using the strategy for fear of infringing the patent, will pay more taxes than otherwise required. A taxpayer would be precluded from filing an amended tax return if some action was required in the applicable tax year to implement the tax strategy.[289] These social costs could be incurred for many years.[290]

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284. *See infra* notes 354-56 and accompanying text (discussing the Patents Depend on Quality Act's requirement that all patent applications be publicized within eighteen months of filing).

285. In these situations, the taxpayer-licensee will be paying the correct amount of tax.

286. 35 U.S.C.A. § 282 (West 2007) ("A patent shall be presumed valid.").

287. *See* CHISUM ET AL., *supra* note 25, at 60 (A patent allows the seller to enjoy a monopoly in the market for the patented product, and "the monopoly price . . . is higher than competitive [prices]").

288. The agreement may restrict the damages available to the licensees. For example, the licensee may be prohibited from obtaining consequential damages.

289. An amended income tax return can be filed only within three years of the due date of the tax return or within two years of when the tax was paid. *See* I.R.C. § 6511(a) (West 2007).

290. One study concluded that when the validity of the patent was considered in a patent infringement lawsuit (which results in a written opinion), the average period between the filing of the patent application and the final determination is twelve years and four months. Allison & Lemley, *supra* note 224, at 236 tbl. 11 (listing the mean for "All Patents"). This study was based on "all written, final validity decisions by either district courts or the Federal Circuit reported in the *United States Patent Quarterly* . . . during an almost eight-year period from early 1989 through

d. Bad Patent Problems Are Not Unique to Tax Strategies

Complaints about bad patents and the related costs are not unique to tax strategies.[291] Complaints about bad U.S. patents can be traced back as early as 1827.[292] The popular press frequently comments on the bad patent problem.[293] Data suggests that the Patent Office eventually approves "as many as 97% of the applications placed before it."[294] "[I]n litigated cases

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1996." *Id.* at 187; *see also id.* at 194 (stating that the population contained 299 patents litigated in 239 cases).

291. Lemley, *supra* note 2, at 1495 ("The [Patent Office] has come under attack of late for failing to do a serious job of examining patents . . . .").

292. *See* JAFFE & LERNER, *supra* note 11, at 128-29 (discussing the patent on the "Winged Gudgeon," which led to a "messy dispute [that] roiled Washington with the Attorney General, Congress, and even the President drawn into the controversy").

293. *See, e.g.*, Editorial, *The EBay Effect* [sic], L.A. TIMES, May 17, 2006, at B12, *available at* 2006 WLNR 8450579 ("The [patent] system yields too many bad patents, particularly when business methods are concerned."); Greg Griffin, *System Patently Out of Date*, DENVER POST, Apr. 10, 2006, at C1, *available at* 2006 WLNR 6047264 ("The United States' system for patenting new innovations isn't working and needs to be reformed . . . . One result is a proliferation of 'bad' patents that protect inventions that aren't really new or innovative, or are just plain obvious."); Grant Gross, *Patent 'Trolls' Are Elusive, Experts Say*, INFOWORLD DAILY NEWS, June 15, 2006, 2006 WLNR 10373720 ("'The overriding problem is the U.S. Patent . . . Office issuing bad patents . . . .'") (quoting Chuck Fish, Time Warner's Vice President and Chief Patent Counsel); Alan Murray, *War on 'Patent Trolls' May Be Wrong Battle*, WALL ST. J., Mar. 22, 2006, at A2 ("[T]here is a problem in the patent world . . . it is bad patents . . . ."); Jeff Nesmith, *'Patent Trolls' Are Saviors to Some Inventors*, MIAMI HERALD, Mar. 20, 2006, at 24G, *available at* 2006 WLNR 4569601 ("Some critics say poor inventions that fail to meet statutory criteria for a patent, such as novelty, utility and non-obviousness, are nevertheless patented because examiners are overworked, . . . rushing undeserving patent applications to approval . . . to meet quotas and improve their annual performance reviews."); Correy E. Stephenson, *Supreme Court Creates New Hurdles for Patent Holders*, DAILY RECORD (St. Louis, Mo.), June 8, 2006, 2006 WLNR 9952659 ("People's confidence in the patent system has been plummeting."); Lorraine Woellert, *eBay Takes on the Patent Trolls*, BUS. WEEK ONLINE, Mar. 30, 2006, 2006 WLNR 5309873 ("[C]urbing . . . injunctions would only mask the symptoms tormenting the patent system, without curbing the disease: a plague of bad patents issued by an underfinanced and hidebound Patent [Office]."); *see also* JAFFE & LERNER, *supra* note 11, at 149 ("The ongoing transfers of resources from the patent office to general government coffers, the widening gap between compensation for examiners in the private and public sectors, the drive for 'productivity' of a dubious sort, and the poor investments made by the [Patent Office] have combined to create a crisis in the quality of issued patents."); *id.* at 34-35 ("[The Patent Office] has become so overtaxed, and its incentives have become so skewed towards granting patents, that the tests for novelty and non-obviousness that are supposed to ensure that the patent monopoly is granted only to true inventors have become largely non-operative."); *id.* at 57 ("[T]he disastrous deterioration in the examination standards of the overworked [Patent Office] has planted the seeds for thousands of noxious patent weeds, which are now fighting with each other—as well as with the valuable flowers and vegetables—to take over the garden.").

294. Thomas, *supra* note 202, at 728 (citing Cecil D. Quillen, Jr. & Ogden H. Webster, *Continuing Patent Applications and Performance of the U.S. Patent and Trademark Office*, 11 FED.

that actually result in a final judgment on [patent] validity, issued patents are held invalid forty-six percent of the time."[295] When patents are "re-examined"[296] for validity, the patent is modified 64% of the time, is completely thrown out 10% of the time, and "comes through unscathed with no changes" 26% of the time.[297] While the tax area may be more prone to social costs from patented inventions that fail to meet the utility requirement,[298] the IRS has authority to publicly rule that a patented tax strategy does not work, which should end the social costs relating to the bad patent. The other two categories of bad patents—patents on inventions that are not novel and patents on obvious inventions—may be just as likely to occur in other industries as in the tax area.[299]

CIR. B.J. 1, 13 (2001-2002)). *But see Patenting of Tax Advice Hearings, supra* note 6 (statement of James A. Toupin, General Counsel, U.S. Patent Office) ("As of mid-year, fiscal year 2006, the allowance rate for business method applications was approximately 20%, which is lower than the overall [Patent Office] allowance rate of approximately 54% at mid-year.").

295. Lemley, *supra* note 2, at 1500. One commentator uses similar statistics. *Patenting of Tax Advice Hearings, supra* note 6 (statement of James A. Toupin, General Counsel, U.S. Patent Office) ("As of mid-year in fiscal year 2006, the allowance rates for business method applications were approximately 20%, which is lower than the overall [Patent Office] allowance rates of approximately 54% at mid-year.").

> [S]tatistics of patent litigation do not bear out any systematic weakness in the patent system.... The University of Houston Law School compiled statistics for patent litigation results from 2000 through 2005 and found that on issues of patent validity, the patent holder won at trial on validity issues 58% of the time, [and] the accused infringer prevailed 42% of the time. If there were tons of bad patents then surely the trial results would be overwhelmingly against the patent holder. But this is not the case.

Perspectives on Patents: Post-Grant Review Procedures and Other Litigation Reforms: Hearing Before the Subcomm. on Intell. Prop. of the S. Comm. on the Judiciary, 109th Cong. (2006) [hereinafter *Myhrvold Testimony*] (testimony of Nathan P. Myhrvold, CEO, Intellectual Ventures), *available at* http://judiciary.senate.gov/testimony.cfm?id=1911&wit_id=5368.

296. *See infra* notes 331-43 and accompanying text (discussing re-examination process).

297. *Myhrvold Testimony, supra* note 295.

298. Presumably in most industries, if an invention does not work, manufacturers, distributors, and customers will quickly realize that the invention does not work, and no one will want to license rights related to the invention or purchase products produced from the patented process. In the tax area, particularly because of the complexity of the rules and the vagaries of IRS enforcement, a taxpayer may profit by licensing the invention and using it to reduce the tax payable with her tax return for many years before the IRS either rules that the tax strategy does not work, or audits her regarding the strategy. Also, the applicable statute of limitations may preclude the IRS from collecting any extra tax avoided by the tax strategy. *See* I.R.C. § 6501(a) (West 2007) (noting that the general statute of limitations is three years from the date the tax return is filed).

299. To avoid issuing patents on old or obvious strategies, the patent examiners need to find and evaluate the prior art. To the extent patent examiners have special difficulty in finding and evaluating the prior art in the tax area, presumably more errors will result in the tax area than elsewhere.

There are several reasons for bad patents. First, a patent examiner, on average, spends only eighteen hours on a patent application, and many of those hours must be spent performing tasks other than searching for prior art and analyzing whether the patent application satisfies the patentability requirements.[300]

Second, the Patent Office is arguably understaffed and underfunded, particularly based on the increase in patent applications.[301] "The National

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300. Lemley, *supra* note 2, at 1500 ("The *total* average time the examiner spends on all these tasks over the two- to three-year prosecution of the patent is eighteen hours."); *see also* JAFFE & LERNER, *supra* note 11, at 136 ("The examiner processing the typical patent spends only sixteen to twenty hours with each patent."); Jeremiah Chan & Matthew Fawcett, *Footsteps of the Patent Troll*, 10 INTELL. PROP. L. BULL. 1, 3 (2005) ("The National Research Council estimates that . . . examiners . . . spend[] an average of only seventeen to twenty-five hours per application from start to finish, including a validity search.").

The examiner needs to perform many tasks. After initially examining the application, if the examiner is satisfied that the invention as described in the application is "patentable," she can issue a "notice of allowance." 37 C.F.R. § 1.311(a) (2006). If the examiner concludes that the requirements for a patent have not been satisfied, the examiner will issue an "Office Action" to the applicant (or her attorney). *Id.* § 1.104(a)(2). The Office Action may reject any or all of the claims set forth in the application. *Id.* § 1.104(c). The applicant must respond to the Office Action within the time required, *id.* § 1.134 ("Unless the applicant is notified in writing that a reply is required in less than six months, a maximum period of six months is allowed."), or the application will be deemed abandoned, *id.* § 1.135. The applicant's response may challenge the basis for any adverse action proposed in the Office Action, and/or may amend the claim(s) that were rejected or challenged by the examiner. *Id.* § 1.111. If the examiner is not satisfied, she can issue a second Office Action (and can issue subsequent Office Actions). *Id.* § 1.104. At any time between the issuance of the initial Office Action and the issuance of a notice of allowance, the applicant or her representative may request a personal or telephone interview with the examiner in an attempt to reach an agreement regarding allowance of the claims. *Id.* § 1.133(b); *see also* Lemley, *supra* note 2, at 1500 (summarizing the steps in a patent prosecution).

301. "Jon Dudas, the undersecretary of Commerce who runs the [Patent Office] . . . acknowledges that the number of examiners in his agency has not kept pace with the workload, even though the number of examiners has nearly doubled since President Bush took office." Nesmith, *supra* note 293, at 24G; *see also Patent Trolls: Fact or Fiction: Hearing Before the Subcomm. on Courts, the Internet, and Intell. Prop. of the H. Comm. on the Judiciary*, 109th Cong. 17 (2006) [hereinafter *Kamen Testimony*] (statement of Dean Kamen, President, Deka Research & Development Corp.), *available at* http://judiciary.house.gov/media/pdfs/printers/109th/28201.pdf ("[O]ne reason this examination process is in need of improvement is because funding for the U.S. [Patent] Office has not kept up with the increased number of patent applications being filed. With the proper funding, I am confident that the U.S. [Patent] Office could find ways to hire, train, retain and reward examiners with the requisite credentials to solve the quality problem at its roots."). Commentators state,

> According to statistics published by the [Patent Office], over 365,000 patent applications were received in 2003. From 1983 to 2003, the number of patent applications received by the [Patent Office] more than tripled, from 112,000 patent applications per year to 366,000. According to a 2004 report published by the National Academies of Science, the number of examiners at the [Patent

Research Council estimates that there are around 3000 examiners handling over 350,000 patent applications annually . . . ."[302] In contrast, the European Patent Office has approximately the same number of examiners as the U.S. Patent Office, but receives "54 percent fewer patent applications, making available roughly twice the manpower to examine each application."[303] "Some critics . . . say that by rushing undeserving patent applications to approval, examiners are able to meet quotas and improve their annual performance reviews."[304] A significant problem is that patent examiners are underpaid, with starting salaries reported as low as $40,000 for new examiners,[305] and only $53,000 for those who have

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> Office] has deceased by 20% over the last four years, leaving a pool of inexperienced examiners to handle an increased number of more complex applications. Thus, it is no surprise that the [Patent Office] approves 85 to 97% of all patent applications filed, or why a significant portion of examiner decisions have been reversed on appeal.

Chan & Fawcett, *supra* note 300, at 3 n.20.

302. Chan & Fawcett, *supra* note 300, at 3.

303. JAFFE & LERNER, *supra* note 11, at 131 (2001 statistics).

304. Nesmith, *supra* note 293, at 24G.

> Bonuses and promotions of patent office employees are based on their productivity, as measured in a very specific way. Patent examiners are given one point when they complete an initial review of a patent and another point when the application is ultimately allowed or rejected. (Various adjustment factors control for the seniority of the examiner and the complexity of the underlying technology.) But applicants can modify and appeal patents that are initially rejected, thereby postponing the earning of the second productivity point. Thus, a rejected patent will typically consume much more of an examiner's time than one that is allowed after the initial application. This scheme creates an obvious incentive for examiners to "go easy" on applicants and allow their patents to be granted.

JAFFE & LERNER, *supra* note 11, at 136.

305. Commentators state,

> Chronically strained for resources, patent office officials have struggled to find qualified examiners, particularly in the "new" areas of software, financial methods, and biotechnology where it had not previously had much expertise . . . . [C]orporations and law firms can offer examiners many times over the approximately $40,000 starting salaries that the government offers. Needless to say, this federal compensation is far less than market rate, especially for the examiners of business method patent applications, who are typically required to have an engineering degree and an MBA, and often have a law degree as well.

JAFFE & LERNER, *supra* note 11, at 12-13; *id.* at 133 ("[T]he patent office has found it difficult to recruit and retain the best examiners.").

either three years of professional experience or graduate studies.[306]

Third, current law merely requires an inventor to list the items of prior art that she is aware of and does not require the inventor to perform a search for prior art.[307] In fact, "applicants face a clear disincentive to explore the prior art thoroughly."[308] Also, the patent examiner has a limited amount of time to search for prior art.[309] Perhaps even more important, "much of the most relevant prior art isn't easy to find—it consists of sales or uses by third parties that don't show up in any searchable database and will not be found by examiners in a hurry."[310]

Fourth, as Professor Lemley persuasively argues in *Rational Ignorance at the Patent Office*,[311] since the vast majority of patents are never licensed

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306. Commentators state,

> [C]onsider a new examiner, beginning at the initial step of the relatively senior grade of GS-11. To qualify for such a position, our new candidate would have to have earned a bachelor's degree in his specialty area (typically biology, chemistry, engineering, or physics), and have either three years' professional experience or graduate study. . . . Under an enhanced salary scale effective January 2002, these candidates would start at $53,000 per year. After twenty years at the organization, having achieved "primary examiner" status, they might expect to be making $100,000. (The average examiner, however, makes approximately $60,000.)
>
> This may be contrasted with the opportunities in the private sector for comparably qualified individuals. Examiners departing the patent office have routinely doubled their salaries when joining law firms and corporate patent departments.
>
> . . . .
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> . . . As a result, by 2001, *55 percent of the examiners had been at the office for two years or less.* Defenders of the status quo might argue that this turnover is an inevitable consequence of running a government agency, but this rate is more than six times as high as that in the European Patent Office.

Id. at 135-36 (emphasis added).

307. 37 C.F.R. § 1.56 (2006).

308. JAFFE & LERNER, *supra* note 11, at 139.

> In particular, a major fear of corporations is "willful infringement." If they are found to have knowingly infringed a patent, they can be liable for three times the damages that they would otherwise need to pay, so a company does not necessarily want to make sure it finds out about all the patents related to a technology it is pursuing. This rule has created incentives for firms to be scanty in their searches.

Id. (citing Robert O. Bolan & William C. Rooklidge, *Imputing Knowledge to Determine Willful Patent Infringement*, 24 AIPLA Q.J. 157 (1996)).

309. *See supra* note 300 and accompanying text.

310. Lemley, *supra* note 2, at 1500.

311. While noting that "*Rational Ignorance at the Patent Office* is an insightful piece," Professor Thomas presents five reasons why he "remain[s] unpersuaded" by Professor Lemley's

or enforced, minimal resources should be expended to initially determine patentability, and procedures should be available to address bad patents that have significant economic consequences.[312] Professor Lemley estimates that only 3.5% of all patents are licensed for royalties,[313] and "at most only about two percent of all patents are ever litigated."[314] Since validity is at issue only for approximately 5% of all issued patents, Professor Lemley points out that 95% of resources devoted to improving the Patent Office's initial patentability determinations would be wasted.[315]

Article. *See* Thomas, *supra* note 202, at 732-40.

312. Professor Lemley states,

> [T]he overwhelming majority of patents are never litigated or even licensed. Because so few patents are ever asserted against a competitor, it is much cheaper for society to make detailed validity determinations in those few cases than to invest additional resources examining patents that will never be heard from again. In short, the [Patent Office] doesn't do a very detailed job of examining patents, but we probably don't want it to. It is "rationally ignorant" of the objective validity of patents, in economics lingo, because it is too costly for the [Patent Office] to discover those facts.

Lemley, *supra* note 2, at 1497.

313. *Id.* at 1507 ("I suspect the total number of patents litigated or licensed for a royalty (as opposed to a cross-license) is on the order of five percent of issued patents.").

314. *Id.* at 1501 (adding that "less than two-tenths of one percent of all issued patents actually go to court").

315. *Id.* at 1511. Professor Lemley states,

> The strong implication of these numbers is that society ought to resign itself to the fact that bad patents will issue, and attempt to deal with the problem ex post, if the patent is asserted in litigation. This result is admittedly counterintuitive. It depends crucially on the fact that very few patents are ever the subject of litigation, or even licensing. Because of this, money spent improving the [Patent Office] examination procedures will largely be wasted on examining the ninety-five percent of patents that will either never be used, or will be used in circumstances that don't crucially rely on the determination of validity.
>
> [The] argument becomes more intuitive if we take the position of [Patent Office] reformers a bit further. Suppose, for example, someone suggested that to minimize the risk of error we should conduct the equivalent of a full trial on validity (say, one thousand hours of examination) before granting a patent. This would certainly reduce the risk of bad patents getting through the system. But most people would rightly think such a suggestion ludicrous and unworkable. Why? Because they intuitively recognize that we simply cannot afford perfect decision making in each of the hundreds of thousands of cases on which the [Patent Office] has to make decisions. We understand rational ignorance on the part of the [Patent Office], in other words—the only question is how much time we *should* spend per patent. From a cost perspective, the answer is not much.

Id. at 1510-11.

e. Patent Examiner Training to Improve Initial Validity Determinations

When testifying about business method patents in 2004, the Patent Office Commissioner highlighted the bad patent issue[316] and discussed several steps to improve validity determinations.[317] In 2006, the Patent Office General Counsel stated that "the [Patent Office] has partnered with the IRS and is currently developing a partnership with the American Bar Association's Section of Taxation to pursue training and information exchange opportunities."[318] In addition, the IRS has conducted "cross-Agency workshop[s]" to "assist the [Patent Office] in developing the resources to determine 'prior art' in the area of tax strategies and structures."[319]

f. The Prior User Defense and Opportunities to Challenge the Validity of a Bad Patent

Although the issuance of a patent creates a presumption that the patent is valid,[320] certain prior users of a business method will not be liable for infringement. In 1999, Congress enacted the American Inventors Protection Act, which includes a limited "prior user right" which is available only to patents on business methods.[321] Under this right, a person who can prove that she had "actually reduced the subject matter to practice at least 1 year before the effective filing date of such patent," will not be

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316. *Bridging the Tax Gap*, *supra* note 14, at 197 ("Others are concerned that patents that have been awarded in these areas, while generally appropriate, may in certain cases be overly broad or not truly novel. These fears raise legitimate issues, and the [Patent Office] has taken a number of steps to address these concerns.").

317. First, in March of 2001, the Patent Office instituted a "Business Methods Patent Initiative," conducting semi-annual "partnership meetings" in which members of impacted industries could provide information to Patent Office examiners. *Id.* Second, the Patent Office significantly increased the number of Patent Office examiners available to work on business method patent applications. The number of patent examiners in this field increased from 17 in 1997 to 106 in 2004. *Id.* at 198. Third, the Patent Office adopted a "second-pair-of-eyes" review for Class 705 (business method) patents, in which a second examiner considers business method patent applications. *Id.* at 198, 200. Fourth, the Patent Office has adopted a "21st Century Strategic Plan" with patent quality as a primary goal. *Id.* at 200-01.

318. *Patenting of Tax Advice Hearings*, *supra* note 6 (statement of James A. Toupin, General Counsel, U.S. Patent Office) (noting that the Patent Office "is actively seeking assistance to assure that it has the best possible information and understanding of the tax strategy area").

319. *Id.* (statement of Mark Everson, Comm'r, IRS).

320. 35 U.S.C.A. § 282 (West 2007).

321. Pub. L. No. 106-113, 113 Stat. 1501, 1501A-555-557 (1999), codified at 35 U.S.C. § 273 (2000).

liable for infringement.[322]

> It is the belief of many that this narrowly tailored provision is a variety of tort reform that has been more than effective in warding-off frivolous patent infringement lawsuits and protecting the public. In fact, there are relatively few recorded infringement suits in the federal courts concerning solely business-method cases.[323]

Thus, certain prior users will not need to challenge the validity of a patent.[324] With respect to tax strategy patents, however, the prior user defense will seldom be available for three reasons. First, the prior user defense will not be available to any tax practitioner if the invention was inspired by a change in the tax law and the first-to-invent files a patent application within one year of the change in the law.[325] Second, the defense is not available if the "tax practitioner . . . is new to the field."[326] Third, and likely most important, the defense will never be available to the *client-taxpayer* unless she has previously used the strategy, regardless of her tax advisor's prior use.[327] If none of the tax advisor's clients can use the tax strategy without committing infringement, as a practical matter, it is irrelevant that the tax advisor may be protected by the prior user defense.

For those who cannot qualify as a prior domestic user, there are several other procedures for challenging the validity of a patent. First, a third party could use the invention, wait for the patent-holder to sue for infringement, and raise invalidity as a defense in the infringement action.[328] However, "[d]efending a patent infringement suit is expensive. Based on a survey of intellectual property lawyers in 2000, the cost of defending a . . . . case[] with less than $1 million at risk . . . was $300,000 to $750,000 or about half the amount in dispute."[329]

Second, in 1984, Congress amended the rules for patent interference proceedings to allow issues of patent validity, as well as priority, to be considered.[330]

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322. *Id.*

323. *Bridging the Tax Gap*, *supra* note 14, at 199. On the other hand, it could be argued that since very few business method patents have been issued, the absence of recorded infringement suits is not surprising and does not reflect the effectiveness of the domestic prior user right.

324. Nevertheless, the existence of the patent may create great anxiety for a user who is uncertain whether the domestic prior user right applies in the particular situation.

325. BACKGROUND AND ISSUES, *supra* note 8, at 26.

326. *Id.* at 26 n.99.

327. *Id.*

328. 35 U.S.C.A. § 282 (West 2007); *see* Kieff, *supra* note 42, at 712 ("Validity issues may be raised as a complete defense to an infringement suit or may support their own declaratory judgment action.").

329. JAFFE & LERNER, *supra* note 11, at 68.

330. *Bridging the Tax Gap*, *supra* note 14, at 199-200; *see also* 35 U.S.C.A. § 135(a) ("The

Third, under "ex parte re-examination"[331] either the patentee or a third-party can petition for re-examination of an issued patent.[332] The legislative purpose for the re-examination statute "is to strengthen 'investor confidence in the certainty of patent rights by creating a system of administrative re-examination of doubtful patents.'"[333] A significant restriction on ex parte re-examination is that "prior art other than patents and other formal publications cannot be considered. . . . [This] restriction . . . severely handicaps third parties in precisely the areas where re-examinations would be most helpful."[334] Thus, prior use could not be considered in an ex parte re-examination.[335] Third parties may request ex parte re-examination on an anonymous basis,[336] but the procedure has been criticized because it allows

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Board of Patent Appeals and Interferences shall determine questions of priority of the inventions and may determine questions of patentability.").

331. 35 U.S.C.A. §§ 301-307.

332. *Id.* § 302.

333. H.R. REP. NO. 96-1307(I), at 3 (1980). For example, a patentee may request re-examination if potential investors question the validity of her patent because the examiner failed to consider an item of prior art that might invalidate the patent. *See* Patlex Corp. v. Mossinghoff, 758 F.2d 594, 601-02 (Fed. Cir. 1985). Ex parte re-examination can be attractive to the patent holder. A House Report issued in connection with the 1980 Act creating the procedure stated,

> The cost incurred in defensive patent litigation sometimes reaches $250,000 [in 1980] for each party, an impossible burden for many smaller firms. The result is a chilling effect on those businesses and independent inventors who have repeatedly demonstrated their ability to successfully innovate and develop new products. A new patent re-examination procedure is needed to permit the owner of a patent to have the validity of his patent tested in the Patent office where the most expert opinions exist and at a much reduced cost. Patent office re-examination will greatly reduce, if not end, the threat of legal costs being used to 'blackmail' such holders into allowing patent infringements or being forced to license their patents for nominal fees.
>
> "The reexamination of issued patents could be conducted with a fraction of the time and cost of formal legal proceedings and would help restore confidence in the effectiveness of our patent system.

H.R. REP. NO. 96-1307(I), at 4 (1980), *quoted in* 4 CHISUM ON PATENTS, *supra* note 35, § 11.07[4].

334. JAFFE & LERNER, *supra* note 11, at 154.

335. Re-examination will be available only if "a substantial new question of patentability" is raised. 35 U.S.C.A. § 303(a). As a result, an objection based solely on prior art considered by the initial patent examiner may not proceed. *See, e.g.*, *In re* Portola Packing, Inc., 110 F.3d 786, 791 (Fed. Cir. 1997). Thus, ex parte re-examination is aimed at situations in which an item (or items) of prior art was not considered by the patent examiner. *See id.* at 789-90 ("Congress . . . was aware that newly-discovered prior art often is identified only after a patent is issued because a potential infringer generally has greater resources and incentives to search for and find prior art than does the [Patent Office] . . . . Accordingly, re-examination was only intended for those instances in which the examiner did not have all the relevant prior art at his disposal when he originally considered the patentability of an invention.").

336. 37 C.F.R. § 1.510(b) (2006).

third parties only "one opportunity to set forth their opinion."[337]

Fourth, in response to some of the problems of ex parte re-examination,[338] Congress created *inter partes* re-examination in 1999,[339] under which a third party can participate in the re-examination proceeding and appeal to the Patent Office's administrative Board of Patent Appeals and Interferences.[340] This procedure "permit[s] third-parties to respond to the patentee throughout the reexamination process."[341] Commentators debate whether this new procedure will help address the bad patent problem.[342] While the number of ex parte re-examinations still greatly exceed the number of *inter partes* re-examinations, the popularity of the new procedure is growing.[343]

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337. CHISUM ET AL., *supra* note 25, at 152. A supporter of ex parte re-examination argues,

> It is the cheapest, simplest and most widely used way to challenge a U.S. patent after it issues.
>
> Ex parte reexamination can be instituted by anyone, and done so anonymously . . . . It is cheap and simple—you submit the prior art, and a legal brief explaining why the provided art invalidates the patent. This simple and inexpensive procedure is relatively popular. There were 524 ex parte reexaminations filed in 2005—which is a rate that is five times the number of patent lawsuits that went to trial that year.

Myhrvold Testimony, *supra* note 295, at 4.

338. H.R. REP. NO. 106-287 Part I, at 30-31 (1999) (containing a portion of the American Inventors Protection Act).

339. 35 U.S.C.A. §§ 311-318.

340. *Id.* §§ 314-315; *see also Bridging the Tax Gap*, *supra* note 14, at 199-200.

341. CHISUM ET AL., *supra* note 25, at 152; *see also* CHISUM ON PATENTS, *supra* note 35, § 11.07[4][g] ("[t]he third-party requester has 'one opportunity to file written comments' on each response by a patent owner . . . .").

342. *Inter partes* re-examination is available only for patents that issue on "original" patent applications filed on or after November 29, 1999. *Myhrvold Testimony*, *supra* note 295, at 4; *see also* 4 CHISUM ON PATENTS, *supra* note 35, § 11.07[4][g]. As in ex parte examination, the Patent Office must find "a substantial new question of patentability" to proceed. 35 U.S.C.A. § 312(a); 4 CHISUM ON PATENTS, *supra* note 35, § 11.07[4][g]. Initially, commentators observed that *inter partes* re-examination was essentially worthless "because anyone who participates . . . must forego their right to challenge validity in court if they are ever sued for infringement on the patent." Lemley, *supra* note 2, at 1525; *see also* 35 U.S.C.A. § 315(c); CHISUM ET AL., *supra* note 25, at 153, 158 ("The inability of a third party requester to appeal a [Patent Office] decision affirming patent claims to the Federal Circuit can be expected to reduce significantly the incentive of third parties to use *inter partes* reexamination, especially because . . . the statute purports to create an estoppel effect against the requester."); Mark D. Janis, *Inter Partes Patent Reexamination*, 10 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 481, 493 (2000). In 2002, Congress adopted amendments in an attempt to address the estoppel issues in connection with *inter partes* re-examination. *See* Changes to Implement the 2002 Inter Partes Reexamination and Other Technical Amendments to the Patent Statute, 68 Fed. Reg. 70,996 (Dec. 22, 2003); 4 CHISUM ON PATENTS, *supra* note 35, § 11.07[4][g] ("Congress clarified the issue, and the [Patent Office] amended Rule 913 'to add the phrase "other than the patent owner or its privies" after "any person,". . . .'").

343. *Myhrvold Testimony*, *supra* note 295, at 5 (noting that there were twenty-one *inter partes*

g. Summary on the Bad Patent Issue—Rules for Post-Grant Review of All Types of Patents Are in Flux

While bad tax patents can create extra costs for inventors, tax practitioners, and taxpayers,[344] many industries are aggressively seeking congressional or Patent Office action to reduce or eliminate the problem.

Representative Lamar Smith, Chair of the House Judiciary Subcommittee on Courts, the Internet, and Intellectual Property, has introduced a bill[345] to reduce the impact of bad patents.[346] Initially, Representative Smith's bill permitted a nine-month "first-window" opportunity and a "second-window" opportunity to challenge a patent.[347] After certain concessions, the second-window period was deleted from the bill,[348] but is still being considered.[349]

Other commentators are suggesting even broader measures, such as: (i) eliminating all software patents;[350] (ii) limiting the strength of a patent based on the contribution by the inventor;[351] and (iii) creating different

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re-examinations in 2003, twenty-seven in 2004, and fifty-nine in 2005). Since *inter partes* re-examinations are available only for patents issued on or after November 29, 1999, these numbers are not insignificant particularly since only approximately one hundred patents go to trial each year. *Id.* There were 524 ex parte re-examinations in 2005. *Id.* at 4.

344. *See supra* notes 274-82 and accompanying text.

345. Patent Reform Act of 2005, H.R. Doc. No. 109-2795 (2005).

346. In 2006, Representative Smith announced that the first subcommittee hearing scheduled on the Patent Reform Act

> [W]ill address the impact of questionable patents and potential issues at the [Patent Office]. H.R. 2795 seeks to address these problems in the following ways:
> - Changes to reexamination and the creation of a post-grant opposition system to "clean up" bad patents on the back end; and
> - Expansion of existing provisions regarding third-party submission of prior art to assist examiners as they review applications.

Rep. Smith Announces New Round of Patent Hearings, U.S. FED. NEWS, Mar. 20, 2006, http://www.allbusiness.com/government/3573877-1.html, *available at* 2006 WLNR 4644769.

347. *Tech Groups Dispute Time Needed to Contest Patents*, WASH. INTERNET DAILY, May 24, 2006, 2006 WLNR 10299492.

348. *Id.* (indicating that the "second window" was removed in exchange for an "easier burden-of-proof standard[] for first-window challengers").

349. *Id.* ("Ranking member Leahy (D-Vt.) said he favors a limited 2nd window . . . .").

350. Griffin, *supra* note 293, at C1 (reporting suggestion by Boulder, Colorado venture capitalist Brad Feld).

351. *Id.* "'We need to recalibrate the system so that the patent owner is entitled to something proportionate to what they actually invent,' said Stanford University law professor and patent specialist Mark Lemley." *Id.* This could be a particularly radical (and fascinating) change for the patent system. Judge Learned Hand stated that substantially all invention is based on the combination of existing items, Safety Car Heating & Lighting Co. v. Gen. Elec. Co., 155 F.2d 937, 939 (2d Cir. 1946) ("Substantially all inventions are the combination of old elements . . . ."), and

classes of patent protection—in particular, allowing a patent applicant to elect to seek a "gold-plate" patent that would "offer better legal protection than standard patents."[352]

In 2006, a different legislative proposal to the bad patent problem was introduced.[353] The Patents Depend on Quality Act of 2006 (PDQ Act) would require that *all* patent applications be made public within eighteen months of filing[354] and would allow a patent examiner reviewing a pending patent application to consider materials submitted by third parties within six months of the date the patent application is made public.[355] The Act would also make the *inter partes* re-examination procedure more attractive to challengers by relaxing estoppel provisions and making the procedure available regardless of when the patent application was filed.[356]

Congress, the Patent Office, and the popular press[357] have all recognized bad patents as a serious problem. "[T]he call for legislative

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the great Isaac Newton allegedly said that if he had seen further than others it was because he "stood on the shoulders of giants," *see supra* note 232. Presumably under the proposed reform, one would consider the extent to which today's inventor was helped by the "giants" of the past. One is reminded of the U.S. Supreme Court's position in 1941 that an invention is not patentable unless it was the result of a "flash of creative genius." Cuno Eng.'g Corp. v. Automatic Devices Corp., 314 U.S. 84, 91 (1941). In 1950, the U.S. Supreme Court appeared to set the bar even higher when it stated, "The conjunction or concert of known elements must contribute something; only when the whole in some way exceeds the sum of its parts is the accumulation of old devices patentable." Great Atl. & Pac. Tea Co. v. Supermarket Equip. Corp., 340 U.S. 147, 152 (1950). In a concurring opinion, Justice Douglas stated that an "invention, to justify a patent, had to serve the ends of science—to push back the frontiers of chemistry, physics, and the like." *Id.* at 154 (Douglas, J., concurring). In the 1952 Patent Act, Congress abolished the "flash of creative genius" test and other related tests for determining patentability, and adopted the "nonobvious" test of 35 U.S.C. § 103. *See* Graham v. John Deere Co. of Kan. City, 383 U.S. 1, 15 (1966) ("It also seems apparent that Congress intended by the last sentence of § 103 to abolish the test it believed this Court announced in the controversial phrase 'flash of creative genius,' used in *Cuno* . . . .").

352. Griffin, *supra* note 293, at C1 ("'You ought to be able to buy yourself a really rigorous examination . . . .'" (quoting Professor Lemley)).

353. The Patents Depend on Quality (PDQ) Act, H.R. Doc. No. 109-5096 (2006) (introduced by Rep. Howard L. Berman, California); 152 CONG. REC. E524, E524 (daily ed. Apr. 6, 2006). The stated goals of the PDQ Act include the following: "To improve patent quality, deter abusive practices by unscrupulous patent holders, and provide meaningful, low-cost alternatives to litigation for challenging patent validity." 152 CONG. REC. E524, E524 (daily ed. Apr. 6, 2006) (statement by Rep. Berman).

354. H.R. 5096, 109th Cong. § 3 (2006) (proposing revision to 35 U.S.C. § 12).

355. *Id.* § 4 (adding 35 U.S.C. § 131(b)).

356. *Id.* § 2 (adding 35 U.S.C. §§ 321-340). As discussed above, currently inter partes re-examination is only available for patent applications filed on or after November 29, 1999. *See supra* note 343.

357. When introducing the PDQ Act, Congressman Berman stated, "The *New York Times* has noted, '[s]omething has gone very wrong with the United States patent system.' The *Financial Times* has stated, '[i]t is time to restore the balance of power in U.S. patent law.'" 152 CONG. REC. E524, E524 (daily ed. Apr. 6, 2006) (statement by Rep. Berman).

action is loud."[358] While the Patent Office may issue bad tax patents, the same measures that will reduce the number and related costs of bad patents generally should have a similar impact in the tax area. Since Congress is analyzing and tackling the problem of bad patents generally, it seems unlikely that Congress would specifically prohibit patents on tax strategies solely because of the bad patent problem.

2. Concerns About the Monopolistic Behavior of Patent Holders in General, and the Potential Problems with Tax Patent "Trolls"

a. Monopoly Power Problems

Although the great majority of patents fail to provide the inventor with any practical economic benefits,[359] some patents provide the inventor with an incredibly valuable economic right. The U.S. patent system grants the first-to-invent a seventeen-year monopoly on the invention.[360] It is true that the inventor must disclose her invention to obtain the patent,[361] which may allow others to "design around" the invention and find an alternative solution to the problem without infringing the patent.[362] Until a noninfringing substitute can be found, however, the inventor can charge a monopoly price.[363] A seventeen-year monopoly could be considered an excessive reward for the inventor's achievement, particularly when the inventor makes a very small but nonobvious advance that others would have achieved shortly after the first inventor. In those cases, the real contribution of the inventor is merely disclosing the invention a few days or weeks before it otherwise would have been disclosed by another. Thus, the ability to charge a monopoly price for seventeen years may be a bonanza for a very modest inventive achievement.[364]

In summarizing the consequences of the bad patent phenomenon with the economic power granted to a patent holder, Professors Jaffe and Lerner state that "in . . . less than a decade, we converted the weapon that a patent represents from . . . a pocket knife into a bazooka, and then started handing

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358. *Id.*

359. Most inventions are never licensed and never the subject of an infringement lawsuit. Lemley, *supra* note 2, at 1497, 1507; *see also* JAFFE & LERNER, *supra* note 11, at 149 ("Every study of the question has suggested that there is a very wide distribution of the value of awards, with a very small fraction of patents accounting for the bulk of the value in all patents.").

360. "The very object of these laws is monopoly." E. Bement & Sons v. Nat'l Harrow Co., 186 U.S. 70, 91 (1902)); *see also supra* note 12 and accompanying text.

361. *See supra* note 230-31 and accompanying text.

362. *See supra* notes 229-35 and accompanying text.

363. *See supra* note 242 and accompanying text.

364. *See supra* note 351 (Professor Lemley argues that the inventor's reward should bear some relationship to the inventor's achievement.).

out the bazookas to pretty much anyone who asked for one, despite the legal tests of novelty and non-obviousness."[365]

In the tax industry, protests over excessive inventor rewards may be especially loud when a tax strategy is based on a new statute, Treasury regulation, or IRS ruling. Tax planning opportunities are made possible by tax rules (or the absence of a rule).[366] When a tax rule is released, tax practitioners at the large accounting firms, law firms, and other tax professionals might pour over the new rules in search of opportunities. Tax practitioners may scramble to become the first-to-invent and claim the seventeen-year prize. This incentive may be unnecessary to promote these tax inventions because others may almost simultaneously invent the same strategy.

These types of complaints are not unique to tax patents. "Worries about detrimental economic effects of granting patents are not new. Rather these debates are almost as old as the institution of the patent grant itself."[367] When Thomas Edison obtained the patent on the light bulb, other inventors were extremely close to the same invention.[368] Further, the public could certainly argue that they should not be required to pay a monopoly price for something that they otherwise could have obtained at a competitive price. This is a cost of the patent system—consumers must pay higher prices until the patent expires.[369] While complaints about patent holders are not new, recently the challengers have sharpened their arguments by referring to certain patent holders as "trolls."[370]

b. Patent Trolls in General

Trolls are "mythical creatures who lived under bridges and kept travelers from crossing with their threats."[371] If patent trolls exist and cause problems, addressing those problems may require re-examining the rights

365. JAFFE & LERNER, *supra* note 11, at 35; *see also id.* at 51 ("[P]atents are blunt instruments.").

366. *See infra* note 409.

367. JAFFE & LERNER, *supra* note 11, at 79.

368. "Edison did not invent the first electric light bulb, but instead invented the first commercially practical incandescent light. Several designs had already been developed by earlier inventors, including the patent[s] he purchased from Henry Woodward and Mathew Evans, Moses G. Farmer, Joseph Swan, James Bowman Lindsay, William Sawyer, Sir Humphry Davy, and Heinrich Göbel." Reference.com, http://www.reference.com/browse/wiki/Thomas_Edison (last visited Feb. 18, 2007).

369. *See* CHISUM ET AL., *supra* note 25, at 60 ("[T]he monopoly price for a good . . . is higher . . . than competitive levels.").

370. *See infra* Part IV.B.2.b.

371. Nesmith, *supra* note 293, at 24G; *see also* Editorial, *Inventing a New System*, L.A. TIMES, Mar. 23, 2006, at B10, *available at* 2006 WLNR 6951394 ("High-tech companies are increasingly running into stop signs waved by patent holders . . . .").

that a patent provides to the patent-holder.

The term "patent troll" has evolved over time, with more and more patent holders being described as trolls. One commentator states that a patent troll is anyone who holds a patent and does not do what you want him to do.[372] The phrase was originally used to refer to companies that purchase a patent merely to sue others for infringement.[373] Other commentators have asserted that any purchaser of a patent can be characterized as a patent troll.[374] The company that won a $612.5 million settlement from the makers of the Blackberry has been described as a patent troll.[375]

Judge Newman, in a 2004 dissenting opinion, discussed an allegation that the patent holder was a patent "predator" or a patent troll because the patent holder acted inappropriately.[376] The majority described the patent holder's behavior as follows: "[T]his appeal continues appellant's pattern of repeatedly filing nonmeritorious infringement complaints and then repeatedly prosecuting nonmeritorious appeals against the spectrum of cell phone manufacturers even though the accused products bear no realistic

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372. *Myhrvold Testimony*, *supra* note 295.

373. *See* Nesmith, *supra* note 293, at 24G. It has been reported that a Chicago firm, TechSearch, was called a patent troll because it purchased the right to sue on a patent that allegedly is violated whenever a retailer processes a credit card transaction. *Id.* The inventor, and the original patent holder, was Paul Ware, who held U.S. Patent Number, 4,707,592 issued on November 17, 1987. *Id.*

> TechSearch, and [its successor], have put more than 200 retailers on notice that they are violating [the] patent. Some, including ExxonMobil Corp., Radio Shack, Gap and more than 20 others, have paid license fees rather than face patent infringement lawsuits. Other companies, including Kroger, Universal Tire and Office Depot, have rejected license fee demands and challenged the patentability of [the] system. A request that the patent office re-examine [the] patent has been filed anonymously.

Id.

374. *See* Chan & Fawcett, *supra* note 300, at 1-2 ("Patent trolls come in a variety of flavors. Some purchase other companies' controversial patents for the purpose of asserting them against an industry . . . . Others are agents that help assert patents on behalf of patent owners for a cut of the action . . . .").

375. *The EBay Effect* [sic], *supra* note 293, at B12 ("[T]he likelihood of an injunction helped prod Research in Motion Ltd., the maker of the Blackberry, to pay patent-holder NTP, Inc. (whose main business is collecting patents and suing on them) a $612.5 million settlement for violating patents related to wireless e-mail."); *see also* Chan & Fawcett, *supra* note 300, at 5 ("NTP is a private holding company whose only assets are a portfolio of wireless email patents. It has been alleged that [NTP's founders] started NTP as a 'kind of virtual company, to make money . . . from patents.'" (quoting Ian Austen & Lisa Guernsey, *A Payday for Patents 'R' Us: Huge Blackberry Settlement Is Grist for Holding Company*, N.Y. TIMES, May 2, 2005, at C1)).

376. Colida v. Sanyo N. Am. Corp., 2004 WL 2853034 at *2 (Fed. Cir. 2004) (Newman, J., dissenting).

similarity to his design patents."[377] Thus, a patent troll could include any inventor who argues that his or her patent has been infringed without a reasonable basis for the lawsuit. The Federal Circuit majority appeared to acknowledge that definition in 2005 when it repeated an allegation that the patent holder was a patent troll because the infringement allegation was "baseless."[378]

In some situations, the definition of a patent troll has been expanded to include any inventor who obtains a patent but does not plan to produce the product.[379] Commentators have referred to MercExchange as a patent troll after its victory in *MercExchange, L.L.C. v. eBay, Inc.*[380] "MercExchange is a failed online travel company that holds a portfolio of patents relating to online services."[381] While multiple issues were involved and both sides won certain issues,[382] the overall result can be described as a victory for MercExchange: The jury found eBay liable for $35 million in damages for willful infringement, and the Federal Circuit affirmed the validity of the patent and the willful infringement holding.[383] When introducing the PDQ Act of 2006, the sponsor of the bill stated,

> [The Act] is designed to address the negative effect on innovation created by patent "trolls." We have learned of

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377. *Id.* at *1; *see also* JAFFE & LERNER, *supra* note 11, at 69 ("Over the course of the 1990s, . . . Rambus engaged in an extended campaign to abuse the patent system and essentially extort licensing royalties from . . . manufacturers.").

378. IP Innovation, L.L.C. v. ECollege.com, 156 Fed. Appx. 317, 324 (Fed. Cir. 2005).

> Docent argues that it presented the district court with substantial evidence demonstrating the baseless nature of IP Innovation's suit. Docent faults IP Innovation for not explaining the nature of its case or its infringement position . . . . Docent accuses IP Innovation of being a patent "troll" that sought to extract a settlement to avoid litigation expenses.

Id. The Federal Circuit rejected Docent's argument that its motion for attorneys fees should have been granted, in part because "five companies with products similar to [Docent's] products took a license to the patented technology, which inferentially supports IP Innovation's argument that it had reasonable grounds upon which to initially bring suit against Docent." *Id.*

379. *See Inventing a New System*, *supra* note 371, at B10 (discussing "companies that do nothing but collect royalties on their patents."); Griffin, *supra* note 293, at C1 ("Of particular concern . . . is the ability of patent holders who don't produce anything to extract large settlements . . . .").

380. 401 F.3d 1323 (Fed. Cir. 2005), *rev'd on other grounds*, 126 S. Ct. 1837 (2006); *see also* Chan & Fawcett, *supra* note 300, at 5 (listing eBay as a technology "stung" by a patent troll).

381. Chan & Fawcett, *supra* note 300, at 5.

382. The Federal Circuit held that (i) one patent was valid, and had been infringed, and the district court's denial of a permanent injunction was an abuse of discretion; (ii) a second patent was invalid; and (iii) factual issues needed to be resolved before deciding the validity of a third patent. *MercExchange*, 401 F.3d at 1326.

383. *See* Chan & Fawcett, *supra* note 300, at 5.

> 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.[384]

Several inventors have objected to being characterized as trolls. For example, Dean Kamen, the President of the corporation that developed the Segway Scooter,[385] argues that while his company does not manufacture in volume, it provides "innovative technology" to its "partners."[386] The company's scientists, engineers, and technicians "make[] the first prototype of a wide range of new products, primarily in the medical field,"[387] and then allow "established corporations to manufacture, market, and sell [the] products."[388] Kamen argues that while some might characterize his company as a troll, its activities provide value to the U.S. economy and are precisely the type of activities that the U.S. patent system should strive to encourage.[389] Kamen asserts that,

> [T]he term patent troll has been applied to a progressively broader range of parties and activities, including:
> - those who don't manufacture products embodying their patent
> - those who offer a license as an alternative to suing for patent infringement
> - those who sue alleged infringers that have products already on the market
> - small entities who sue large entities with deeper pockets
> - those who don't "use" their patent
>
> Not only are these activities typically legitimate and

384. 152 CONG. REC. E524, E524 (daily ed. Apr. 6, 2006) (testimony of Rep. Howard L. Berman) (emphasis added). Representative Berman complains that the patent holder can automatically obtain a permanent injunction if the patent is valid. *Id.* However, after Representative Berman's statement, the U.S. Supreme Court made it much more difficult for a patent holder to obtain a permanent injunction. *See* eBay, Inc. v. MercExchange, L.L.C., 126 S. Ct. 1837 (2006). After *eBay*, a patent holder must satisfy the traditional four-part test to obtain a permanent injunction. *Id.* at 1839. The traditional test requires, in part, that the plaintiff show "irreparable injury" to obtain a permanent injunction. *Id.*

385. *See* Gross, *supra* note 293.

386. *Kamen Testimony*, *supra* note 301, at 15.

387. *Id.*

388. *Id.*

389. *Id.* at 15-16.

> constructive, they, in fact, represent part of the intended purpose of the U.S. patent system.[390]

Similarly, the CEO of another research and development firm argues that the problem with the U.S. patent system is not patent holders per se, but rather patent holders who act badly and "serial infringers" who abuse the intellectual property rights of inventors.[391]

In effect, there is substantial disagreement about who is a patent troll.[392] Nevertheless, Congress is in the process of defining patent trolls and developing legislation to deal with actual and potential problems.

c. Tax Practitioners and Tax Professors as Patent Trolls

Many inventive tax planners who obtain patents could be patent trolls, depending on the definition of a patent troll. It appears that the only way a patent holder can avoid being called a troll is by mass producing the patented product and satisfying the entire market demand for the product.[393]

Tax professors could become patent trolls. As soon as a new tax statute, ruling, or case is issued, tax professors could study the new law to find a patentable loophole. Once the patent application is filed,[394] the tax professor could publish articles describing the technique in the most prominent industry publications. For example, after obtaining the SOGRAT patent, the inventor published an article in *Estate Planning Magazine*, a leading journal in the estate planning field.[395] The SOGRAT

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390. *Id.* at 15.

391. *See Myhrvold Testimony*, *supra* note 295.

392. Even law firms have been accused of being patent trolls.

> Some high-profile law firms are even getting in on the act. Robins, Kaplan, Miller & Ciresi in Minneapolis is risking its own capital to help exploit its clients' IP on contingency. Dallas' McKool Smith has been given the keys to license patent portfolios from companies such as Ericsson, Lockheed Martin, and the State University of New York—all on a contingency basis.

Chan & Fawcett, *supra* note 300, at 2 (citations omitted).

393. While this patent-holder would not be called a patent troll, she would be called a monopolist. The patent-holder would have no competitors, the patent holder would charge a monopoly price, and would sell only to those willing to pay the monopoly price. *See supra* note 242 and accompanying text.

394. Since the United States currently grants patents to the first-to-invent, rather than the first-to-file a patent application, the tax professor could discuss or publish the new loophole for up to twelve months before filing the patent application. *See* 35 U.S.C.A. § 102 (West 2007) ("A person shall be entitled to a patent unless . . . the invention was . . . in public use or on sale in this country, more than one year prior to the date of the application for patent in the United States . . . .").

395. Robert C. Slane, Heidi C. Freeman & Krishine E. Simmons, *Efficient Use of Nonqualified*

article clearly states that the strategy is patented and prominently displays the name, city, state, and email address of the patent holder, presumably to encourage tax advisors to request and purchase a license.[396]

Tax professors might have some difficulty spotting infringers since a tax return position claimed by a particular taxpayer is generally confidential, but tax professors might have success spotting infringers by reviewing the marketing materials of law firms and CPA firms to determine which firms are pushing the patented tax strategy.

d. Should Congress Prohibit Patents on Tax Strategies Because of Potential Troll Problems?

Presumably, inventive tax patent trolls could create the same problems as trolls in other industries—the holder of a tax patent could (i) purchase a tax patent with the sole intention of suing infringers and reaping large settlements;[397] (ii) send frivolous demand letters to other tax advisors and their clients in an attempt to generate settlement payments from firms that are reluctant to incur legal fees defending an infringement suit;[398] or (iii) seek to delay the publication and issuance of a patent in hopes that other tax advisors will independently invent the tax strategy, commit substantial resources to its development,[399] and interest their clients in the strategy. After the tax advisors have taken these steps, the patent troll may be in a position to demand substantial fees for a license.

Congress is conducting hearings in an attempt to define a patent troll[400] and is considering legislation to limit the powers of patent holders.[401]

Stock Options as a Wealth Transfer Vehicle, EST. PLAN., Sept. 2005, at 26, 26.

396. *See id.* at 26 n.A1.

397. This business model may appear particularly attractive after NTP Inc. purchased a patent, sued the makers of the Blackberry, and won a $612.5 million settlement. *See supra* note 375 and accompanying text.

398. Judge Newman acknowledged that alleged infringers will have to consider infringement defenses a cost of doing business as long as U.S. courts maintain the "American Rule" that each party to a lawsuit generally must bear its own attorneys fees. *See* Colida v. Sanyo N. Am. Corp., 2004 WL 2853034, at *2 (Fed. Cir. 2004) (Newman, J., dissenting).

399. For example, the firm may have marketed the strategy to its major clients who will become very unhappy if the firm cannot use the technique for fear of infringing the patent. This strategy would not be available against competitors that "actually reduced the subject matter [of the invention] to practice at least one year before the effective filing date of [the] patent, and commercially used the subject matter before the effective filing date of [the] patent." First Inventor Defense Act of 1999, Pub. L. No. 106-113, 113 Stat. 1536 (codified as amended at 35 U.S.C. § 273(b)(1) (2000)).

400. Gross, *supra* note 293 ("The goal of Thursday's [legislative] hearing . . . was to define so-called patent trolls . . . .").

401. Chan & Fawcett, *supra* note 300, at 7 ("The [Patent Reform Act of 2005] resets the table on issues of liability and remedies in ways that will . . . discourage patent trolls. By lowering the threshold for invalidating a patent . . . the [Patent Reform Act] lowers the risk that a successful

Moreover, the U.S. Supreme Court has made it more difficult for patent holders, including patent trolls, to obtain permanent injunctive relief.[402] The inability to obtain permanent injunctive relief automatically in a patent infringement lawsuit will remove a tremendous weapon that previously allowed patent holders to automatically shut down an infringing competitor's business.[403] The Supreme Court's decision in *eBay* may allow competitors in certain situations to enjoy a "compulsory license" in the patented product because the competitor can choose to infringe the patented process and pay money damages for the infringement.

In addressing the problems caused by patent trolls, Congress may reconsider the fundamental rights granted to patent holders. Potential issues may include the following:

(i) Who should be entitled to patents?;
(ii) Should patents be granted only to parties capable of manufacturing or otherwise using the technology?;
(iii) Who should be able to purchase or otherwise acquire a patent from an inventor?;
(iv) What level of due diligence must a patent holder exercise before sending a demand letter to stop the alleged infringement?;
(v) What sanctions should be imposed on patent holders who send frivolous demand letters?; and
(vi) What remedies should be available to a patent holder if a competitor infringes the patent?

As Judge Newman stated when introducing the term patent troll to case law, "the possible potential remedy is complex and its implications manifold."[404]

Before taking any further action aimed at patent trolls, Congress may wait to consider the impact of the U.S. Supreme Court's decision in *eBay v. MercExchange, L.L.C.*, which limits the patent holder's right to obtain a permanent injunction.[405] In any event, since the problems caused by tax

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[infringement suit] will kill a company . . . ."); *see also Inventing a New System*, *supra* note 371, at B10 ("[L]ately the federal government has been struggling to fix a patent system that prizes inventors too much.").

402. *See* eBay Inc. v. MercExchange, L.L.C., 126 S. Ct. 1837 (2006).

403. Prior to the U.S. Supreme Court's decision in *eBay*, Professors Jaffe and Lerner stated, "[T]he [Federal Circuit] enabled patentees to shut down a rival's business (through a preliminary injunction) even before a patent was proven valid . . . ." JAFFE & LERNER, *supra* note 11, at 111.

404. Colida v. Sempo N. Am. Corp., 2004 WL 2853034, at *2 (Fed. Cir. 2004) (Newman, J., dissenting); *see also Inventing a New System*, *supra* note 371, at B10 ("The [legislative] activity reflects a growing sense in Washington that the patent system has lost its moorings.").

405. *See eBay*, 126 S. Ct. at 1841. One commentator has stated, "[T]he balancing tests laid out for the courts will significantly reduce the negotiating leverage of firms whose sole business is amassing obscure patents and collecting fees from potential infringers." *The Ebay Effect*, *supra* note

patent trolls will be similar to the problems caused by all types of patent trolls, it seems unlikely that Congress will take special action in the tax area solely because of these problems.

3. Is Tax Planning "Evil"?

As discussed above, in *Juicy Whip, Inc. v. Orange Bang, Inc.*, the Federal Circuit stated that Congress, not the Patent Office or the courts, is responsible for "declar[ing] particular types of inventions unpatentable."[406] If tax planning is evil, presumably Congress should exercise its power to prohibit tax strategy patents on public policy grounds.

a. Determining Whether Tax Planning Is Evil

For purposes of this discussion, the word "evil" can be defined as "harmful or injurious"[407] or contrary to public policy. Initially, it can be noted that Judge Learned Hand indicated that tax planning is a right.

> [A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose[s], to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. Therefore, if what was done here, was what was intended by section 112(i)(1)(B) [of the Internal Revenue Code], it is of no consequence that it was all an elaborate scheme to get rid of income taxes, as it certainly was.[408]

293, at B12; *see also* Stephenson, *supra* note 293 ("'[T]his opinion . . . [will] lead courts to say plaintiffs who don't actually practice their invention, or who are not competing with the defendant, won't get injunctions.'" (quoting Tony Fitzpatrick, a prominent patent litigator)).

406. 185 F.3d 1364, 1368 (Fed. Cir. 1999). The Federal Circuit states,

> As the [U.S.] Supreme Court put the point more generally, "Congress never intended that the patent laws should displace the police powers of the States, meaning by that term those powers by which the health, good order, peace, and general welfare of the community are promoted."
>
> Of course, Congress is free to declare particular types of inventions unpatentable for a variety of reasons . . . . *Cf.* 42 U.S.C. § 2181(a) (exempting from patent protection inventions useful solely in connection with special nuclear material or atomic weapons).

Id. (quoting Webber v. Virginia, 103 U.S. 344, 347-48 (1880)).

407. WEBSTER'S NEW UNIVERSAL UNABRIDGED DICTIONARY 672 (2003).

408. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465, 470 (1935); *see also* Comm'r v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting) (citations

Judge Hand's assertion of a right to tax plan has been the basis for scholarly debate.[409]

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omitted). Many cases have cited this principle. *See* David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 220 n.14 (2002).

409. *See* Deborah Schenk, *Foreward*, 55 TAX L. REV. 125, 133-34 (2002) ("[T]hese are two very depressing issues of the Tax Law Review. . . . [The experts] cannot even agree on such a fundamental idea as whether taxpayers have a right to tax plan."). Professor Weisbach asserts that a "right" is "something profound or inviolate," and in any federal tax situation Congress can amend the statute to take away the tax planning angle. Weisbach, *supra* note 408, at 221 ("[I]f the so-called right is based merely on language in the statute, nothing stops Congress from changing the language."). Professor Weisbach concludes that, "There [is] . . . no 'right.' Instead, there may be a privilege granted in the statute. . . ." *Id.* He states,

> There is no right to engage in tax planning in the Constitution or any other foundational documents of our society. And the right to alter behavior to minimize taxes is not a basic principle of moral philosophy. Tax planning does not, for example, rank with the freedom of thought, speech, association, religion, or other principles supported by moral philosophers.

Id.

New York Attorney Michael Schler agrees: "[T]he often-stated 'right' of taxpayers to engage in tax planning is purely a matter of legislative grace that can be removed by Congress at any time." Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 328 (2002); *see also id.* at 384 ("Likewise, [Weisbach] is surely correct that 'the right to alter behavior to minimize taxes is not a basic principle of moral philosophy.'"). However, Schler goes on to state,

> Weisbach . . . is unfair to Learned Hand and others who have spoken of the right of taxpayers to engage in tax planning . . . . Judge Hand is simply describing the rights of taxpayers under the existing Code, not the right of taxpayers under natural law. Surely Judge Hand did not mean to say that Congress could not constitutionally restrict tax planning.

Id. at 384-85.

Since the Sixteenth Amendment to the Constitution merely authorizes Congress to impose an income tax, U.S. CONST. amend. XVI ("The Congress shall have power to lay and collect taxes on income, from whatever source derived . . . ."), almost all federal income tax rules flow from the applicable statute, the Internal Revenue Code. Some constitutional questions can arise—for example, a taxpayer may argue that an item is not "income" and cannot be taxed under Congress's power to collect an income tax, regardless of the statutory language enacted by Congress, *see* Eisner v. Macomber, 252 U.S. 189 (1920) (determining that stock dividends are taxable income), or that an expense must be deductible notwithstanding Congress's statutory language because otherwise the tax would be imposed on gross receipts rather than income. NEWMAN, *supra* note 24, at 135 ("[N]et income, not gross income, is the only fair way to measure ability to pay in an income tax. . . . it is the net profits, not the gross receipts, which give us a workable measurment.") Nevertheless, the vast majority of federal tax issues are resolved by referring to either the Internal Revenue Code or treasury regulations. Accordingly, when discussing tax planning, it seems completely appropriate to presume that Congress has enacted a statute specifying what constitutes

Since commentators cannot even agree on whether there is a right to engage in tax planning, it is not surprising that they disagree on whether tax planning is evil. Professor Weisbach asserts that tax planning "is almost always positively bad for society,"[410] with certain exceptions. Professor Weisbach states,

> [A]ll tax planning, not just planning associated with . . . [tax] shelters, produces nothing of value. Nothing is gained by finding new ways to turn ordinary income into capital gain, to push a gain offshore, or to generate losses. No new medicines are found, computer chips designed, or homeless housed through tax planning. At a minimum, defenders of tax planning must justify why we should care about a nonproductive activity.[411]

Professor Weisbach even states that "[t]ax planning is like *polluting*."[412] He argues that someone who reduces her taxes through tax planning imposes costs—in the form of higher taxes—on others in society in the same way that a polluter imposes costs—such as clean-up costs—on others in society.[413] Professor Weisbach states that, "[t]here is nothing in this analysis to distinguish [tax] shelters from all other [tax] planning" and concludes that "all tax planning should be eliminated if possible, subject only to the cost of doing so."[414]

In support of this view, Professor Weisbach chooses, in his own words, a "silly" example—Congress passes a law that anyone who can perform a backflip can reduce her taxes by 10%.[415] In the first scenario of this example, only some people do backflips, and as a result, the backflippers will reduce their taxes. All the non-backflippers will pay higher taxes, and that is a bad result because there is no reason that the backflippers should pay less tax than the non-backflippers.[416] In the second scenario of this

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income, *see, e.g.*, I.R.C. § 61 (West 2007), and what is deductible from income, *see, e.g.*, I.R.C. § 162. As a result, a taxpayer can be described as having a right to arrange her affairs to minimize taxes under the current statutory structure, subject to the risk that Congress will retroactively amend the statute.

410. Weisbach, *supra* note 408, at 222.

411. *Id.*; *see also* Yablon, *supra* note 1, at 153 ("'Tax-motivated behavior ought to be discouraged . . . because tax planning produces nothing of value to society. It may benefit the taxpayer whose taxes are reduced, but the social product is not increased.'" (quoting Martin J. McMahon Jr.)).

412. Weisbach, *supra* note 408, at 223 (emphasis added).

413. *See id.* at 223 (analogizing tax planning to an economic externality).

414. *Id.* at 224.

415. *Id.* at 222.

416. *Id.* at 223. Note that this bad result occurs because the tax rule is "silly." If the tax distinction under the statute were appropriate, presumably it would be appropriate for those who qualify for the tax break to pay less tax.

example, everyone does a backflip, everyone's taxes stay the same, and "everyone is worse off because they had to do the backflip."[417]

A problem with Professor Weisbach's analysis is that it proceeds from an assumption that the tax law is silly. Presumably the great majority of federal tax laws are not silly, and those that are silly are likely to be amended or repealed soon after enactment.[418] Instead, most of the tax laws are attempts either to properly define "income" or to promote some economic activity that Congress desires to encourage.

Not surprisingly, after Professor Weisbach sets out a general rule that "[t]ax planning is like polluting,"[419] he provides a series of exceptions that arguably swallow up his general proposition.[420] First, Professor Weisbach states that "if Congress intended taxpayers to receive a particular treatment for a general type of transaction but required a particular form to get the treatment, helping taxpayers meet the requirements seems to be socially valuable."[421] This exception likely includes most tax planning. Presumably when Congress, the Treasury Department, or the IRS adopts a tax rule, it has made a conscious decision that if certain conditions exist, the taxpayer should be taxed in a certain way.[422] In other words, when a tax practitioner helps arrange a transaction so that certain tax-beneficial conditions exist, the tax practitioner is following Congress's directions and providing a socially valuable service under Professor Weisbach's analysis.

Second, Professor Weisbach states that, "[i]f Congress intends to subsidize or penalize a particular activity through the tax system, changes in behavior because of the tax may be desirable."[423] Professor Weisbach attempts to cabin this second exception by stating, "[T]his type of tax planning is limited to *explicit* subsidies or penalties in the tax system and is not at stake in the statements generally made about the value of tax

417. *Id.* at 223.

418. Tax laws that may appear silly may have been adopted to encourage a certain behavior. For example, it could certainly be argued that it is silly to allow taxpayers to deduct interest on a second mortgage, while denying a tax deduction for interest paid on a car loan. I.R.C. § 163(h) (West 2007). However, the deduction encourages home ownership.

419. Weisbach, *supra* note 408, at 223.

420. *See* Schler, *supra* note 409, at 386.

421. Weisbach, *supra* note 408, at 224.

422. For example, Congress amended I.R.C. § 1031 to allow gains to be deferred in like-kind exchanges on a tax-free basis. I.R.C. § 1031(a) (1982), *amended by* Pub. L. 98-369 § 77(a) (1984). Presumably, this change was intended to measure income properly. Taxpayers must satisfy various requirements for the exchange to be tax-free under I.R.C. § 1031. *Id.* The taxpayer must identify "exchange property" within 45 days, close on the exchange property within 180 days, and meet several other requirements. *Id.* § 1031(a)(3). Under Professor Weisbach's analysis, all the tax planning involved in the I.R.C. § 1031 exchange transaction should be considered "socially valuable."

423. Weisbach, *supra* note 408, at 224.

planning."[424] Nevertheless, this second exception appears almost as broad as the first exception and likely encompasses almost all tax planning. When Congress, the Treasury Department, or the IRS adopts a tax rule and "draws a line," presumably it has made a judgment that certain behavior will be rewarded and contrary behavior will not. To use Professor Weisbach's terms, "Congress intends to subsidize . . . a particular activity through the tax system."[425] This can be observed in an area as mundane as corporate liquidations. In *George L. Riggs, Inc. v. Commissioner*,[426] the parent corporation owned 70% of the stock of the subsidiary corporation.[427] Congress provides in the Internal Revenue Code that a parent corporation can liquidate a subsidiary corporation tax-free if it owns at least 80% of the subsidiary's stock.[428] The tax court recognized that Congress intended to subsidize liquidations of 80% subsidiaries, not 70% subsidiaries.[429] The parent corporation's tax lawyer engineered a series of pre-liquidation transactions to boost the parent corporation's ownership interest to at least 80%.[430] If Professor Weisbach wanted to argue that the tax lawyer's actions in *Riggs* were "evil," he might assert that Congress did not intend to provide a subsidy in the corporate liquidation context and that "we might want to require Congress to specify all intentional subsidies and the manner in which they may be used to allow clear identification of the remaining socially harmful tax planning."[431] Again, this seems unnecessary because Congress, the Treasury Department, and the IRS are aware that every time a tax rule "draws a line," behavior on one side of the line will be "subsidized" and behavior on the other side of the line will be "penalized."[432]

Third, Professor Weisbach states that "tax lawyers acting as [tax] return preparers help interpret the law and ensure compliance, and that these functions are socially valuable."[433] If helping to "interpret the law and ensure compliance" is socially valuable, one may ask why routine tax

424. *Id.* at 224-25 (emphasis added).

425. *Id.* at 224.

426. 64 T.C. 474 (1975).

427. *Id.* at 479.

428. I.R.C. § 332(a) (West 2007) (referencing 80% requirement of I.R.C. § 1504(a)(2)).

429. *Riggs*, 64 T.C. at 488-89 ("The purpose of [the predecessor of IRC § 332(a)] was to encourage the simplification of corporate structures . . . . The [legislative history] seems inescapably to reflect a legislative understanding . . . that taxpayers can, by taking appropriate steps, render [IRC § 332(a)] applicable or inapplicable . . . .").

430. *Id.* at 478-80. The corporation redeemed "sufficient shares of common stock to give the [corporation] at least 80 percent of the [subsidiary's] common stock." *Id.* at 480.

431. Weisbach, *supra* note 408, at 225 n.22.

432. Since Congress intended to provide a subsidy if the parent corporation owns at least 80% of the subsidiary's stock, the tax attorney's actions in the *Riggs* situation were "desirable" under Professor Weisbach's second exception. *See supra* notes 423-25 and accompanying text.

433. Weisbach, *supra* note 408, at 224.

advice, which clearly helps both the client and the client's tax return preparer in interpreting the law, is not also socially valuable.

Fourth, Professor Weisbach states that, "[T]ax lawyers representing clients on audit or in litigation perform basically the same role as others in our adversary system. There is nothing any better or worse about tax lawyers in this context than lawyers representing clients before tribunals more generally."[434] If clients are entitled to zealous representation during a tax audit or litigation, one can question why the client is not entitled to zealous representation in planning and implementing a transaction. As a practical matter, a taxpayer planning a transaction is often "building a record" for an anticipated tax audit, and the documents to carry out the transaction are expected to be exhibits in the tax dispute.[435] If the client's tax lawyer provides a worthwhile service once the tax audit begins, why are the attorney's services in preparation for that audit evil?[436]

While Professor Weisbach's analysis is thought-provoking, a more useful framework is provided by Los Angeles tax attorney Joseph Wyatt.[437] In contrast to Professor Weisbach, who argues that, except in certain circumstances, tax planning is evil, Wyatt indicates that whether tax planning is evil depends on the type of tax planning involved.[438] At one end of the extreme, tax planning that constitutes fraud is evil.[439] This conclusion finds support because ethical, civil, and criminal penalties may be imposed for engaging in that type of tax planning.[440] "At the other

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434. *Id.*

435. For example, if a client wishes to establish a family limited partnership to arrange for the management of assets, facilitate tax-free gifting to relatives, and reduce estate tax, the partnership agreement, certificate of limited partnership, documents to transfer assets to the partnership, gift documents, and all the appraisals will be crucial evidence in the estate tax audit or litigation. *See, e.g.*, Kimbell v. United States, 371 F.3d 257 (5th Cir. 2004) (reversing district court decision for failure to consider uncontroverted record evidence to support the taxpayer's position that transaction was a bona fide sale).

436. Professor Weisbach provides a fifth exception—"where there is an obvious wart on the tax system and tax lawyers help clients plan around the problem." Weisbach, *supra* note 408, at 225. However, as Professor Weisbach points out, tax planning in this situation likely is appropriate only if there is a legitimate way of structuring the transaction to avoid the unfair tax (and if there is a legitimate way to avoid the tax, query whether there is truly a "wart" on the tax system or merely an open manhole with a detour available). As Professor Weisbach appropriately states, "It is generally not a defense to a violation of the law that the law is stupid . . . . It is, therefore, not clear that we should think that planning around warts in the law is socially valuable." *Id.*

437. *See* Joseph L. Wyatt, Jr., *Ethics in Estate Planning Tax Practice: When Does Aggressive Planning Go Over the Line?* (ALI-ABA Course of Study, Sept. 12-13, 2002) WL SH019 ALI-ABA 957.

438. *Id.* at 199.

439. *Id.* ("[T]he practitioner is clearly prohibited from advising or participating in a 'sham' or fraudulent transaction or one that is intended to conceal or mislead [the IRS].").

440. *Id.* at 199 n.70; *see also* I.R.C. § 6701 (2000) (establishing penalties for aiding and abetting an understatement of tax liability); IRS Circular No. 230, § 10.51(b) (Rev. June 20, 2005)

extreme, the practitioner is generally free to recommend to the client any tax plan in which the tax benefits are certain to be sustained . . . [because] [t]he government's interests are fully protected . . . ."[441] Wyatt's analysis not only provides us with rules for extreme cases, but also it provides criteria for analyzing cases closer to the center—or as Wyatt states, closer to the "line."[442]

If a tax strategy violates the tax law and results in the client paying less than her fair share of tax, the client is like an illegal polluter, unfairly creating extra costs for other members of society.[443] However, if the tax strategy complies with the tax law—in other words, if the tax strategy works—then the taxpayer pays her fair share of taxes. She is not *unfairly* shifting costs to other taxpayers, and the "government's interests are fully protected."[444] Wyatt appropriately points out that there is often great uncertainty over whether a tax plan complies with the tax laws—in other words, whether the tax planning will enable the client to pay the correct amount of tax or will enable the taxpayer to avoid paying her fair share, shifting costs to others in society, much like a polluter.[445]

b. Tax Inventors Will Not File Patent Applications for Evil Tax Strategies Because of the Transparency of the Patent System

Since some tax planning is evil and some tax planning is not,[446] it is necessary to consider which type of tax strategies inventive tax practitioners will try to patent.

(providing false or misleading information); *id.* at § 10.51(j) (providing a false or misleading opinion); MODEL RULES OF PROF'L CONDUCT R.1.2 cmt. 12 (2002).

441. Wyatt, *supra* note 437, at 199 (emphasis added).

442. *Id.* at 203 ("'The ultimate question that constantly recurs in the practice of tax law [is] where 'the line' is between acceptable tax planning and unacceptable overreaching . . . .'" (quoting James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles*, 55 TAX L. REV. 135, 136 (2002))).

443. Weisbach, *supra* note 408, at 223.

444. Wyatt, *supra* note 437, at 199. In this situation, Professor Weisbach might argue that the tax planner is still a "polluter" because costs, in the form of tax liability, are being shifted to others in society. While tax planning in this situation will shift a tax burden onto those who cannot (or choose not to) engage in tax planning, the key difference is that the tax planning (or the polluting) is not illegal. If the taxpayer is not acting illegally, in the words of Judge Hand, she is simply "arranging [her] affairs as to keep [her] taxes as low as possible." Comm'r v. Newman, 159 F.2d 848, 851 (2d Cir. 1947) (Hand, J., dissenting); *see also supra* note 408 and accompanying text. In other words, she is simply paying the correct amount of tax.

445. Wyatt, *supra* note 437, at 199 ("Most planning issues encountered by the [tax] practitioner . . . do not generally involve issues of fraud, but instead arise in situations where there is considerable uncertainty whether a proposed course of action will or [will not] withstand legal analysis if challenged by the IRS.").

446. *See supra* notes 438-45 and accompanying text.

i. The Tax Strategy and the Name of the Inventor Will Be Publicly Disclosed if a Patent Application Is Filed

In general, a taxpayer taking a risky position on a tax return is not obligated to "red-flag" the issue for the IRS.[447] However, as part of the basic bargain of the patent system, the patent—and in many cases, the patent application—will be publicly disclosed.[448] The patent applicant must tell the public how the invention works to obtain the seventeen-year monopoly.[449] Also, the inventor's name must appear on the patent application and the inventor must sign an oath, even if she has assigned her rights to her employer or another party.[450] Under current law, the Patent Office will publish a patent application eighteen months after it is filed, but there is an exception if the applicant certifies that she will not seek foreign patent rights pertaining to that invention.[451] A congressional bill has proposed eliminating the eighteen-month period, which would force all patent applications to be publicly disclosed promptly after filing.[452]

This transparency will have a dramatic effect on the type of tax strategies that will be patented for at least two reasons: (i) disclosure will prevent tax advisors from seeking patents for "audit lottery" tax positions[453] and (ii) disclosure will create substantial adverse consequences if a tax strategy fails.

ii. Transparency Will Help Determine the Type of Tax Strategies That Will Be Patented

Many tax strategies that taxpayers and their tax advisors might use on a tax return are unlikely to be the subject of a patent application because of the disclosure requirements. As Wyatt appropriately points out, in the

447. Tax positions taken on an income tax return that are not supported by substantial authority must be specifically disclosed on the tax return to avoid penalties. I.R.C. § 6662(d)(2)(B)(ii)(I) (West 2007). Also, the IRS requires that certain "listed transactions" be specifically disclosed. *See* I.R.S. Notice 2006-6, *available at* 2006 WL 33736.

448. CHISUM ET AL., *supra* note 25, at 68.

449. In particular, the patent application must "contain a written description of the invention, and of the manner and process of making and using it, in such full, clear, concise, and exact terms as to enable any person skilled in the art to which it pertains . . . to make and use the [invention]." 35 U.S.C. § 112 (2000).

450. *See id.* § 115 ("The applicant shall make [an] oath that he believes himself to be the original and first inventor of the process . . . for which he solicits a patent . . . ."); *see also* SCHECHTER & THOMAS, *supra* note 35, at 234-35.

451. *See* 35 U.S.C. § 122(b); SCHECHTER & THOMAS, *supra* note 35, at 230. Many tax strategies designed to reduce U.S. tax likely will not be appropriate for foreign patenting. Thus, under current law the patent application would not be automatically disclosed eighteen months after the filing date.

452. Patents Depend on Quality Act, H.R. 5096, 109th Cong. § 3 (2006).

453. Wyatt, *supra* note 437, at 172.

absence of disclosure requirements, taxpayers and their advisors frequently will play the "audit lottery":

> Promoters understand that the IRS is unlikely to detect and challenge more than a small fraction of transactions. They also view applicable penalties as minor and usually avoidable. They put these factors together to make a compelling case that the transaction makes economic sense even though the transaction would not withstand judicial scrutiny. They play the so-called "audit lottery," relying on the probability that they [will not] get caught.[454]

As a result, from a purely economic standpoint, taxpayers and their advisors may decide to engage in a tax strategy and claim a position on an income tax return, even though the chance of success if challenged is less than 50%. Wyatt discusses the rather grim ethical situation this creates for the taxpayer and her advisor:

> There is often no moral disapproval associated with these activities; taxpayers tend to believe that they are only doing what comes naturally, an attitude that colors their financial, investment, and business decisions with the notion that tax avoidance is universal, and that—like "Mom and apple pie"—tax avoidance is American .... This moral philosophy, coupled with the absence of sufficiently intense oversight ("it's unlikely I'll be audited"), have encouraged taxpayers and their advice-providers to expand what never was a bright line into a broad and multi-shaded penumbra where permissible avoidance or minimization shades into impermissible avoidance or evasion.[455]

However, since a patent will be publicly disclosed, a tax inventor will not be able to avoid IRS scrutiny of a patented tax strategy. Furthermore, in the future, the IRS may adopt procedures that will enable them to audit the tax returns of all taxpayers using a particular patented tax strategy.[456] As a result, a tax inventor likely will not submit a patent application unless she is very confident the tax strategy will succeed.

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454. *Id.*

455. *Id.*

456. BACKGROUND AND ISSUES, *supra* note 8, at 23 ("[T]he IRS and Treasury could amend the reportable transaction regulations to include the application, grant, or use of a tax strategy patent (either of one's own patented strategy, or pursuant to a license from the patent-holder). . . .").

iii. Transparency Can Lead to Significant Negative Consequences for the Inventor if the Tax Strategy Fails

Normally, tax information is confidential,[457] and communications between a taxpayer and her tax advisor are privileged.[458] Thus, normally a tax practitioner can orchestrate a tax strategy and advise the taxpayer to take an aggressive position on a tax return without concern that his actions will become a matter of public knowledge. However, if the tax practitioner files a patent application on a tax strategy, the inventor's name, a detailed description of the inventor's strategy, and other information about the strategy will be publicly disclosed.[459] Thus, while tax planning normally can be done under cover of darkness, patented tax planning is performed in the bright sunshine. As a result, it is not surprising that after studying the issued tax patents and the pending applications, the IRS Commissioner told a congressional subcommittee that the IRS had "found little evidence to suggest that tax shelters or aggressive tax avoidance transactions are being patented."[460]

The risks of filing a patent application are demonstrated by a series of patent applications involving a strategy called "reverse split-dollar."[461] Beginning in 1955, the IRS issued a series of rulings specifying the income tax consequences for arrangements described as "split-dollar."[462] Generally, in a split-dollar agreement, one party pays all the premiums on a life insurance policy, and if the agreement terminates during the insured's lifetime, the party paying the premiums will be entitled to the greater of the following: (i) the total premiums paid or (ii) the cash surrender value of the policy.[463] If the insured dies during the term of the split-dollar agreement, the other party—typically the insured or a trust for the insured's family—will be entitled to the policy death benefit in excess

457. *See* I.R.C. § 6103(a) (West 2007) ("[Tax] returns and [tax] return information shall be confidential, and except as authorized by [the Internal Revenue Code] . . . no . . . person . . . who has or had access to returns or return information . . . shall disclose any return or return information . . . .").

458. *See* I.R.C. § 7525(a); *supra* note 130 (quoting the statute).

459. As discussed above, the patent will be available to the public. *See supra* note 229-31 and accompanying text.

460. *Patenting of Tax Advice Hearings*, *supra* note 6 (statement of Mark Everson, Comm'r, IRS).

461. *See* U.S. Patent App. No. 20030105701, Ser. No. 125904 (published June 5, 2003) (Apparatus and Method for Implementing and/or Administering a Wealth Transfer Plan); U.S. Patent App. No. 20030130939, Ser. No. 043991 (published July 10, 2003) (Wealth Transfer Plan Using in Kind Loan Repayment with Term Insurance Protection); U.S. Patent Application No. 20030130935, Ser. No. 043984 (published July 10, 2003) (Wealth Transfer Plan Using in Kind Loan Repayment with Term Insurance Protection for Return of Note).

462. *See* Rev. Rul. 55-713, 1955-2 C.B. 23; Rev. Rul. 64-328, 1964-2 C.B. 11.

463. *See* Rev. Rul. 64-328, 1964-2 C.B. 11.

of the amount payable to the party paying the premiums.[464] In 1955, the IRS ruled that the substance of the transaction was an interest-free loan;[465] unfortunately for the IRS, at that time an interest-free loan generated no taxable income.[466] In 1964 the IRS abandoned its view that split-dollar is an interest-free loan, and instead, in an apparent attempt to generate tax revenue, ruled that one of the parties to the agreement (the non-premium payer) receives an annual taxable "economic benefit" equal to the value of the term insurance coverage provided each year.[467] In this apparent attempt to generate high amounts of taxable income, the IRS encouraged the use of the so-called "P.S. 58 rates," which in many cases would be significantly higher than the actual cost of term insurance coverage.[468]

The patent applications claim "reverse" split-dollar strategies.[469] In reverse split-dollar, the parties to the split-dollar agreement switch positions and receive different benefits under the life insurance policy than in traditional split-dollar agreements; specifically, the premium-payer will be entitled to a portion of the death benefit—as if the premium payer were buying term life insurance—while the non-premium payer will be entitled to the balance of the policy benefits.[470] When the P.S. 58 rates are used to measure the benefits, which the premium-payer must pay for, the premium-payer can transfer substantial wealth free of estate and gift taxes to the other parties.[471] Thus, the reverse split-dollar patent applications describe transactions in which an older generation family member can transfer significant wealth to her children and grandchildren free of gift and estate taxes.[472] The inventor was quoted by a New York Times reporter as saying, "'I'm not saying this is the best thing since sliced bread, but it's really good for pushing wealth forward tax free.'"[473]

In effect, the IRS elected to use aggressive valuation tables—the P.S. 58 rates—in 1964 to collect excessive income taxes. In early 2002, the inventors apparently claimed various reverse split-dollar strategies (under

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464. *Id.* Upon the death of the insured during the term of the split-dollar agreement, the party paying the premiums would normally receive the greater of the premiums paid or the cash surrender value. *Id.*

465. *See* Rev. Rul. 55-713, 1955-2 C.B. 23.

466. *Id.*

467. *See* Rev. Rul. 64-328, 1964-2 C.B. 11.

468. *Id.* (referring to the "P.S. 58 rates" which are set forth in Rev. Rul. 55-747, 1955-2 C.B. 228); *see also* IRS Tech. Adv. Memo 94-52-004 (Dec. 30, 1994) (stating that P.S. 58 rates had to be used because the insurer did not issue term life insurance policies).

469. *See infra* note 474.

470. Richard L. Harris, *Reverse Split-Dollar Entered Into Before Notice 2002-59: Legitimate or Not?*, EST. PLAN., Feb. 2004, at 69, 69-70.

471. *Id.*

472. *Id.*

473. David Cay Johnston, *Death Still Certain, but Taxes May Be Subject to a Loophole*, N.Y. TIMES, July 28, 2002, at A1, *available at* 2002 WLNR 4019769 (quoting Jonathan G. Blattmachr).

three patent applications, two dated January 9, 2002 and the third dated April 18, 2002)[474] that would "turn the tables" on the IRS to allow taxpayers to avoid gift and estate taxes.[475] The IRS was not amused, and a reporter for the *New York Times* was incensed.[476]

Apparently, the inventors marketed the reverse split-dollar strategy, and the *New York Times* reporter found a few clients willing to talk.[477] On July 28, 2002 and August 17, 2002, the *New York Times* ran front-page articles denouncing the reverse split-dollar tax strategies.[478] Almost immediately,

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474. The inventors filed four patent applications on January 9, 2002, but only two of the four applications appear to involve reverse split-dollar arrangements. *See* U.S. Patent App. No. 20030130939, Ser. No. 043991 (published July 10, 2003) (Wealth Transfer Plan Using in Kind Loan Repayment with Term Insurance Protection). Paragraph 14 of the Description states that "ownership, responsibilities and benefits of the insurance policy may be governed by a split-dollar agreement," and the Abstract states that "[t]he economic benefit may be determined according to IRS Table PS58. The economic benefit may be significantly greater than the actual cost of the policy, with the spread being effectively transferred to the transferee." *Id.*; *see also* U.S. Patent App. No. 20030130935, Ser. No. 043984 (published July 10, 2003) (Wealth Transfer Plan Using in Kind Loan Repayment with Term Insurance for Return of Note). Again, paragraph 14 of the Description refers to a split-dollar agreement, and the Abstract refers to the P.S. 58 rates and "the spread being effectively transferred to the transferee." *Id.*; *cf.* U.S. Patent App. No. 20030105690, Ser. No. 043988 (published June 5, 2003) (Method and Apparatus for Establishing and Administering a Charitable Gift Transfer Plan); U.S. Patent App. No. 20030105691, Ser. No. 043990 (published June 5, 2003) (Method and Appartus for Transferring Wealth). Neither of these applications appear to refer to the P.S. 58 rates.

The inventors filed another patent application that appears to involve a reverse split-dollar arrangement on April 18, 2002. U.S. Patent App. No. 20030105701, Ser. No. 125904 (published June 5, 2003) (Apparatus and Method for Implementing and/or Administering a Wealth Transfer Plan). Paragraph 36 of the Description refers to a "split-dollar agreement" and paragraph 40 of the Description refers to the Table P.S. 58 rates. *Id.*

475. In other words, the IRS over-reached (by imposing income tax with an artificially high set of rates, namely the P.S. 58 rates), and then discovered they might be hoisted by their own petard.

476. *See* Johnston, *supra* note 473, at A1.

477. *Id.*

478. The first article states in part:

> [S]ome of the wealthiest older Americans have been buying huge life insurance policies on themselves. . . .
>
> . . . .
>
> . . . [E]ach dollar spent on this [life] insurance can typically eliminate $9 in taxes. Spend $10 million on this insurance, [and] avoid $90 million or more in income, gift, generation-skipping and estate taxes.
>
> . . . .
>
> . . . [Critics] say it effectively disguises a gift to one's heirs that should be taxed like any other gift. . . .
>
> Several thousand of these jumbo policies have been sold, according to agents who sell them, all under confidentiality agreements with the buyers and their advisors. One member of the Rockefeller family took out a policy . . . .

the IRS issued a notice[479] asserting that reverse split-dollar was not authorized under existing law.[480] Eventually, Treasury regulations were issued changing the law to clearly indicate that reverse split-dollar agreements would not be permitted.[481]

The inventors were sued for malpractice by clients in June of 2003.[482] An article about the lawsuit stated that the family's lawsuit was inspired by the *New York Times* articles[483] and reported the fees that one family paid to the inventors. The attorney was paid $970,000 for "work done on the deal and a tax opinion," while the insurance agents and brokers received commissions of $4.4 million.[484] In considering the IRS audits, the

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> The several billion dollars of this insurance already sold, much of it in the last 18 months, means that tens of billions of taxes will not flow into federal and state government coffers in the coming decade or so.
>
> In recent months, polices with first-year premiums alone of $4.4 million, $10 million, $15 million, $25 million, $32 million and $40 million have been sold....
>
> The [life insurance] agents selling the policies find them had to resist—they can earn millions of dollars for selling just one such policy.

Id. The second article states in part:

> The Treasury Department banned a technique yesterday that thousands of the wealthiest Americans have used to escape billions of dollars in gift and estate taxes....
>
> The [Treasury] department said the technique was not valid and never had been, leading experts on taxes and insurance to predict that people who have bought these policies will be drawn into years of litigation with the government and with their advisers.
>
> ....
>
> [One commentator stated,] "Those who bought these policies will be embroiled for years in litigation,"... with the I.R.S., with their lawyers and with the insurance agents who sold them the policies. He and others said it was less likely that the insurance companies that sold the policies... would be drawn into the litigation.

David Cay Johnston, *U.S. Bans a Method to Avoid Estate Tax with Life Insurance*, N.Y. TIMES, Aug. 17, 2002, at A1, *available at* 2002 WLNR 4087016.

479. IRS Notice 2002-59, 2002-2 C.B. 481, *available at* 2002 WL 1880519.

480. The IRS approach, as to prior law, can be questioned. *See generally* Harris, *supra* note 470, at 69 (analyzing whether a reverse split-dollar entered into before I.R.S. Notice 2002-59 would be taxed as a gift).

481. *See* Treas. Reg. § 1.61-22(d)-(g) (2003).

482. *See* Wendy Davis, *Wealthy Family Sues Famous Lawyer over Tax Plan* (July 9, 2003), http://www.markcolbert.com/AKO%20case.html. In discussing why the family sued the inventor, the family's attorney stated, "The itch that they had was scratched by the *New York Times* and then drew blood . . . ." *Id.*; *see also* David Cay Johnston, *Wealthy Family Is Suing Lawyer Over Tax Plan*, N.Y. TIMES, July 19, 2003, at C1, *available at* 2003 WLNR 5668201.

483. *See* Davis, *supra* note 482.

484. *Id.*

lawsuits, and other consequences relating to the use of these techniques, one commentator stated, "I think a lot of people will be in deep yogurt."[485]

As a final attack, in 2004, the *New York Times* reporter wrote a book titled, *Perfectly Legal: The Covert Campaign to Rig Our Tax System to Benefit the Superrich—and Cheat Everybody Else*.[486] The first two words of Chapter One are the inventor's name.[487] In the book, the inventor is described as an attorney who advises the rich on how to save taxes, and "[t]here's no free lunch. [The inventor's] clients just leave part of their bill on your table. . . . It's a subsidy of the super rich paid for by the middle class and the upper middle class."[488] Thus, as a result of the reverse split-dollar strategy, the inventor is essentially a "reverse" Robin Hood, allowing the rich to save tax dollars at the expense of the poor—or at least at the expense of the less wealthy.

This demonstrates that the stakes are high for the tax inventor submitting a patent application. On one hand, if the tax strategy fails, her clients who implemented the strategy may be audited by the IRS, the inventor may be sued by her clients, and the inventor may be publicly criticized. On the other hand, if the tax strategy works, the inventor could obtain a seventeen-year monopoly on the strategy,[489] subject to the risk that Congress, the Treasury Department, or the IRS will change the law.[490] As a practical matter, as long as the United States continues to use the first-to-invent system for granting patents, tax advisors may find it appropriate to request an advance ruling from the IRS regarding the tax strategy before filing a patent application.[491]

As Wyatt indicates, tax planning is evil when it assists the taxpayer in committing fraud and tax planning is acceptable when it allows the taxpayer to pay the correct amount of tax, because the "government's interest is protected."[492] While cutting-edge tax planning will be near "the line"[493] because patent applications will be made public, tax inventors will

485. Johnston, *U.S. Bans a Method to Avoid Estate Tax with Life Insurance*, *supra* note 478, at A1 (quoting Stephan Leimberg).

486. DAVID CAY JOHNSTON, PERFECTLY LEGAL (2004).

487. *See* Joel C. Dobris, *Taxpayers of America Unite!*, 143 TRS. & ESTS., Apr. 2004, at 61, 61.

488. JOHNSTON, *supra* note 486, at 1, *quoted in* Dobris, *supra* note 487, at 61; David Cay Johnston, *The Way We Live Now: 12-21-03: Encounter; The Loophole Artist*, N.Y. TIMES, Dec. 21, 2003, at F6, *available at* 2003 WLNR 5645398 ("[The inventor] helps the super rich keep their riches—at the expense of everyone else.").

489. *See supra* note 12 and accompanying text.

490. *See infra* Part IV.C.4.

491. Since the patent application must be filed within one year, *see supra* note 394, this approach would be appropriate only if the IRS were to issue a favorable advance ruling before the expiration of that one-year period.

492. *See supra* notes 437-42 and accompanying text.

493. *See supra* notes 437-42 and accompanying text.

likely seek patent protection only on tax strategies that work. Such tax strategies are not evil because they allow the taxpayer to pay the correct amount of tax and the "government's interest is protected."[494]

C. *Arguments to Permit Patents on Loopholes*

1. The "Natural Law" Policy Rationale for Granting Patents

Occasionally commentators attempt to use a "natural rights" theory to justify the patent system and other laws that protect intellectual property, such as copyright and trade secret.[495] "The most celebrated proponent of natural rights [was] the seventeenth century English philosopher John Locke . . . ."[496] The natural rights theory asserts that "individuals should enjoy a property entitlement to the products of their labors," and, as applied to inventors, would assert that "innovators . . . should be entitled to enjoy the fruits of their labors, by being granted . . . exclusive rights in their works."[497] "[T]he Lockean explanation of intellectual property has immediate, intuitive appeal: it seems as though people *do* work to produce ideas, and that the value of these ideas—especially since there is no physical component—depends solely upon the individual's mental 'work.'"[498]

While a natural rights theory may justify providing some economic reward to an inventor,[499] the natural rights theory fails to explain the precise contours of the U.S. patent system. For example, why is the term of the patent arbitrarily set at twenty years from the date the application is filed?[500] Why are treble damages available for willful infringement?[501] Why is a person who independently develops the same invention after the first inventor not entitled to patent rights[502] and is instead subject to a suit for infringement?

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494. *See supra* notes 437-42 and accompanying text.

495. *See* Wendy J. Gordon, *A Property Right in Self Expression: Equality and Individualism in the Natural Law of Intellectual Property*, 102 YALE L.J. 1533, 1540-83 (1993); Lawrence C. Becker, *Deserving to Own Intellectual Property*, 68 CHI-KENT L. REV. 609, 620-21 (1993); Justin Hughes, *The Philosophy of Intellectual Property*, 77 GEO. L.J. 287, 296-330 (1988).

496. SCHECHTER & THOMAS, *supra* note 35, at 12.

497. *Id.* at 13.

498. Hughes, *supra* note 495, at 300, *quoted in* CHISUM ET AL., *supra* note 25, at 41.

499. The reward may not necessarily be a patent. One might argue that rights similar to copyright could be more appropriate.

500. *See supra* note 12.

501. 35 U.S.C. § 284 (2000); *see also* CHISUM ET AL., *supra* note 25, at 1359 (noting that "increased damages are punitive . . . . The type of conduct that can justify increased damages is usually referred to as willful infringement.").

502. *See* 35 U.S.C. § 273.

In contrast, the utilitarian theories offer answers to these different questions—presumably the twenty-year duration provides the appropriate incentive to invent and commercialize; the potential for treble damages provides inventors with the appropriate level of assurance that competitors will respect their patent rights; and no patent or other economic prize is given to the second-to-invent because the patent system seeks to encourage novel and nonobvious inventions that can improve the quality of life, create jobs, and strengthen the U.S. economy,[503] rather than encouraging people to ignore current development and "re-invent the wheel."

The U.S. Constitution adopts the utilitarian justification for patent rights.[504] It provides that Congress shall have the power "[t]o *promote* the Progress of Science and useful arts by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries."[505] Furthermore, as Thomas Jefferson adroitly argued, on closer examination there is nothing "natural" about allowing private individuals to own ideas.[506] While an individual can possess tangible property and hide that property from others, the only natural way an individual can maintain exclusive ownership of an idea is to keep it secret, which in many cases will require that the inventor never use the idea.[507] Jefferson wrote,

> [T]he moment [an idea] is divulged, it forces itself into the possession of every one, and the receiver cannot dispossess himself of it. . . . That ideas should freely spread from one to another over the globe, for the moral and mutual instruction of man, and improvement of his condition, seems to have been peculiarly and benevolently designed by nature, when she made them, . . . like the air in which we breathe . . . . *Inventions then cannot, in nature, be a subject of property. Society may give an exclusive right to the profits arising from them, as an encouragement to men to . . . produce utility . . . .*
>
> . . . [T]he exclusive right to invention [is] given not of natural right, but for the benefit of society . . . .[508]

Attempting to justify tax loophole patents under a natural rights theory is especially difficult. First, tax loopholes are inherently unnatural because

503. *See supra* Part IV.A.1.

504. *See* CHISUM ET AL., *supra* note 25, at 38-39.

505. U.S. CONST. art. I, § 8, cl. 8 (emphasis added).

506. Letter to Isaac McPherson (Aug. 13, 1813), *reprinted in* CHISUM ET AL., *supra* note 25, at 45.

507. *Id.*

508. *Id.* (emphasis added).

they spring from tax statutes, regulations, or other rules (or the absence of these rules).[509] In the absence of a tax system, which itself can be viewed as an unnatural intangible construction, there would be no loopholes. Second, while tax planning is not always evil,[510] tax loopholes do not improve the quality of life for society. Third, the natural rights theory begins with the notion that the inventor "deserves" a reward. Since a tax planner usually knows the extent of his or her client base, it would seem that the tax planner understands the potential value of finding a new tax loophole. Allowing the tax planner to exploit the tax loophole beyond her client base arguably is more in the nature of a windfall than an expected benefit. Fourth, as described above, to the extent one person or group has exclusive rights to a tax loophole, it is unfair for all similarly situated taxpayers.[511]

2. Potential Benefit to the Tax Industry—Encouraging "Transparent" Tax Planning Rather Than "Extreme Audit Lottery" Tax Planning

The transparency of tax planning is a major issue. In general, tax return information is confidential[512] and communications between a client and her tax advisor are privileged.[513] At the same time, the U.S. tax system relies on voluntary compliance, or at least self-reporting.[514] This secrecy and taxpayer discretion can significantly diminish taxpayer confidence in the system—taxpayers may conclude that their neighbors are not paying their fair share of taxes, which may encourage greater non-compliance.[515]

Tax strategies may be divided into three categories. First, there are tax strategies that are "more likely than not" to work. Second, there are tax strategies that are more likely to fail, but which are supported by "substantial authority."[516] Generally a tax strategy must have at least a 33% chance of prevailing on the merits to have substantial authority.[517] Even if a substantial authority tax strategy fails on audit or in court, no accuracy-related penalty will apply.[518] Third, a taxpayer may decide to try a tax position on her return despite a lack of substantial authority for the

509. *See supra* note 409.

510. *See supra* Part IV.B.3.

511. *See supra* Part IV.A.3.

512. I.R.C. § 6103(a) (West 2007).

513. *Id.* § 7525(a)(1).

514. On the other hand, wages and various other types of income are subject to income tax withholding, which tends to make the U.S. tax system less voluntary.

515. Wyatt, *supra* note 437, at 172 ("[T]axpayers tend to believe that . . . tax avoidance is universal, and that—like "Mom and apple pie"—tax avoidance is American.").

516. I.R.C. § 6662(d)(2)(B)(i).

517. *Id.* § 6662(d).

518. *Id.* § 6662(d)(2)(B)(i).

position, particularly if the taxpayer is relying on the "audit lottery." The audit lottery is the chance that the client will not be audited, meaning that neither the IRS nor the courts will challenge the position.[519] As Wyatt points out, the ethics of audit lottery tax planning are troubling.[520] If there is no realistic possibility of success on the merits and the taxpayer is just hoping to win on the audit lottery, that type of audit lottery tax planning could be called "Extreme Audit Lottery Tax Planning," or just cheating. Presumably, it will be beneficial in the long run for general taxpayer morale and confidence in the tax system if audit lottery tax planning is discouraged. Current law imposes a penalty equal to 20% of the related tax deficiency if a taxpayer takes a position on a tax return that is not supported by substantial authority, unless the strategy is specifically disclosed on the tax return.[521] As discussed earlier, tax inventors likely will submit patent applications only for strategies that are more likely than not to succeed because the patent system is transparent.[522] Thus, offering patents as economic prizes for tax strategies encourages tax gurus to develop more tax strategies that are more likely than not to succeed.

However, offering patents on tax strategies likely will have no impact on the level of audit lottery tax planning because tax inventors will not seek patents on such strategies.[523] Accordingly, this argument does not support patenting tax strategies.

3. Preserving a Technology-Neutral Patent System

When testifying before the Senate Finance Committee about tax-strategy patents, the Commissioner of Patents stated that the "patent system is *technology neutral* and there shall be no disparate treatment for different categories of inventions," and indicated that granting patents on tax strategies and other business methods furthers that goal.[524] Thus, supporters of tax-strategy patents may argue that adopting special rules to prohibit or restrict tax-strategy patents would tend to erode both the technology-neutral nature of the patent system and all the benefits that flow from maintaining such a system.

The U.S. patent system has been applied to evolving technologies for more than 210 years.[525] Some commentators have argued that the patent

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519. *See supra* text accompanying note 454.

520. Wyatt, *supra* note 437, at 172.

521. I.R.C. § 6662(a).

522. *See supra* Part IV.B.3.b.

523. Those engaged in audit lottery tax planning simply will not submit patent applications for those strategies, so the availability of patent protection is irrelevant in those circumstances.

524. *Bridging the Tax Gap*, *supra* note 14, at 197 (emphasis added).

525. Dan L. Burk & Mark A. Lemley, *Is Patent Law Technology Specific?*, 17 BERKELEY TECH. L.J. 1155, 1158 (2002) [hereinafter Burk & Lemley, *Technology-Specific*] ("A patent statute

system has worked extremely well in fulfilling the utilitarian justifications for the patent system—providing incentives to invent, commercialize, design around, and disclose new inventions,[526] although other commentators have not been as supportive.[527]

a. Is the Patent System Technology-Neutral or Technology-Specific?

With few exceptions, the same statutory standards are used to determine if an invention is patentable, regardless of the field of invention.[528] Accordingly, the patent system has been described as "unitary."[529] While an invention must be within the statutory subject matter to be patentable, the statutory subject matter is extremely broad—"*any* new and useful process, machine, manufacture or composition of matter, or any new and useful improvement thereof."[530] The United States Supreme Court has acknowledged the breadth of the patent system in stating that patentable subject matter includes "'anything under the sun that is made by man.'"[531] Also, all inventions seeking patent protection are

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was one of the first laws Congress passed, in 1790."); *see also* 35 U.S.C. § 1 (2000) (establishing the Patent and Trademark Office); Burk & Lemley, *Technology-Specific*, *supra*, at 1159 ("Despite periodic revisions, most recently in 1952, the basic structure of the patent system has remained unchanged for 165 years.").

526. *Bridging the Tax Gap*, *supra* note 14, at 195 ("[O]ur Founding Fathers designed an extremely flexible patent system based on principles that have proven remarkably suitable to 210 years of technological advancement . . . . [T]he patent system has withstood the test of time."); Kieff, *supra* note 42, at 699 ("Economic research has shown that the national patent system has an important impact on long term international economic competitiveness and that patent law can function as a public policy tool for promoting national economic growth.").

527. *See* Burk & Lemley, *supra* note 202, at 1580 ("There is no unanimity . . . about whether the patent system actually succeeds. Among legal and economic theorists, the patent system has staunch defenders, vocal critics, and those who cannot decide whether the system is good or bad." (footnote omitted)); JAFFE & LERNER, *supra* note 11, at 2 ("[T]he patent system—intended to foster and protect innovation—is generating waste and uncertainty that hinders and threatens the innovative process.").

528. *See* Burk & Lemley, *Technology-Specific*, *supra* note 525, at 1156 ("Patent law has a general set of legal rules to govern the validity and infringement of patents in a wide variety of technologies. With very few exceptions, the statute does not distinguish between different technologies in setting and applying legal standards."); *see also* Burk & Lemley, *supra* note 202, at 1576 ("With only a few exceptions, the statute does not distinguish between different technologies in setting and applying legal standards." (footnote omitted)). The major exceptions are inventions that are "useful solely in the utilization of special nuclear material or atomic energy in an atomic weapon," and certain medical or surgical procedures. *See supra* notes 208-09 and accompanying text.

529. Burk & Lemley, *Technology-Specific*, *supra* note 525, at 1157.

530. 35 U.S.C. § 101 (2000) (emphasis added). One exception is that inventions relating to atomic weapons are not patentable. *See supra* note 208 and accompanying text.

531. Diamond v. Chakrabarty, 447 U.S. 303, 309 (1980) (quoting the congressional committee

subject to the novelty and nonobvious requirements.[532]

The nonobvious test was enacted in 1952 specifically to establish a national standard for determining whether an advancement was worthy of patent protection.[533] The duration of patent protection is also uniform—twenty years from the date that the patent application is filed.[534] Similarly, all patent applications will be published eighteen months after the date of filing, unless the applicant certifies that she will not seek patent protection in a foreign country that publishes after eighteen months.[535] Also, the general statutory definition[536] and the remedies for infringement[537] tend to be technology-neutral.[538] Congress created the

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reports accompanying the 1952 Act, which recodified the patent laws). Three specific areas of subject matter are excluded from patent protection—(i) laws of nature, (2) natural phenomena, and (3) abstract ideas. *Id.* at 309; *Bridging the Tax Gap*, *supra* note 14, at 195-96. Also, different rules apply to design patents, *see, e.g.*, 35 U.S.C. § 173 (granting a fourteen-year patent term for design patents), and plant patents, *id.* §§ 161-164.

532. *See* 35 U.S.C.A. §§ 102-103.

533. Prior to the 1952 Act, courts applied a variety of approaches in deciding whether a patent should issue. In 1850, the U.S. Supreme Court considered whether a new doorknob was patentable. Hotchkiss v. Greenwood, 52 U.S. 248 (1851). The only difference between the new doorknob and the prior art was that the new doorknob used a clay or porcelain knob rather than a metal knob. *Id.* at 264. The Court stated,

> The difference is formal, and destitute of ingenuity or invention. . . .
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> . . . [F]or unless more ingenuity and skill in applying the old method of fastening . . . were required . . . than were possessed by an ordinary mechanic acquainted with the business, there was an absence of that degree of skill and ingenuity which constitute essential elements of every invention.

Id. at 266-67. In 1941, the U.S. Supreme Court stated that a patent would issue only if the invention was the result of a "flash of creative genius." Cuno Eng'g Corp. v. Automatic Devices Corp., 314 U.S. 84, 91 (1941). In 1950, in a concurring opinion, Justice Douglas stated that an "invention, to justify a patent, had to serve the ends of science—to push back the frontiers of chemistry, physics, and the like." Great Atl. & Pac. Tea Co. v. Supermarket Equip. Corp, 340 U.S. 147, 154 (1950) (Douglas, J., concurring). In 1952, Congress enacted the "nonobvious" test as a "statutory substitute that would . . . apply to all kinds of inventions, would restrict the courts in their arbitrary, *a priori* judgments on patentability, and . . . serve as a *uniform standard of patentability*." Giles S. Rich, *Laying the Ghost of the "Invention" Requirement*, 1 AIPLA Q.J. 26 (1972), *reprinted in* NONOBVIOUSNESS—THE ULTIMATE CONDITION OF PATENTABILITY 1:508 (John F. Witherspoon ed., 1980); *see generally* CHISUM ET AL., *supra* note 25, at 532-36 (discussing nonobviousness).

534. 35 U.S.C. § 154(a)(2) (establishing rule for patents filed after June 8, 1995); *see* SCHECHTER & THOMAS, *supra* note 35, at 238.

535. 35 U.S.C. § 122(b)(1)(A) (2000) (establishing general rule that applications will be published); *id.* § 122(b)(2)(B) (establishing an exception if a foreign patent will not be requested).

536. *Id.* § 271.

537. *Id.* §§ 281, 283-287.

538. However, a patent on a medical or surgical procedure cannot be enforced against a health care provider or related entity. *Id.* § 287(c).

Federal Circuit in 1982 and granted that court exclusive jurisdiction over appeals from U.S. district courts regarding patent matters[539] in an attempt to create uniformity in the patent laws.[540]

While the patent statutes are technology-neutral, the courts can introduce some flexibility by applying those statutes in different ways to different fields of technology.[541] Commentators argue that the courts have *applied* the patent statutes in a technology-*specific* manner by making inconsistent assumptions about the level of skill possessed by the person having ordinary skill in the art.[542] This permits patent law to "adapt to new technologies without losing its essential character."[543]

b. Advantages of Maintaining a Technology-Neutral Patent Statute

There are advantages to maintaining a uniform patent statute, and negative consequences could flow from enacting different statutory provisions for each different technology. In discussing proposals to prohibit or restrict patents on business methods in general, attorneys Kuester and Thompson urge extreme caution before taking any technology-specific measures.

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539. 28 U.S.C. § 1295.

540. H.R. REP. No. 97-312, at 20-22 (1981) ("A single court of appeals for patent cases will promote certainty where it is lacking to a significant degree and will reduce, if not eliminate, the forum-shopping that now occurs."); S. REP. No. 97-275, at 5 (1981) ("The creation of the [Federal Circuit] will produce desirable uniformity in . . . [patent] law. Such uniformity will reduce the forum-shopping that is common to patent litigation."); *see generally* CHISUM ET AL., *supra* note 25, at 26-28 (discussing the Federal Circuit); JAFFE & LERNER, *supra* note 11, at 100-01 ("Lawmakers reassured constituents that the change would bring much-needed consistency to the volatile world of patent litigation.").

541. Two commentators state,

> [W]e have noticed an increasing divergence between the rules themselves and the application of the rules to different industries. The best examples are biotechnology and computer software. [The courts have applied the nonobvious, enablement, and written description requirements differently to different types of inventions.] As a practical matter, it appears that while patent law is technology-*neutral* in theory, it is technology-*specific* in application.

Burk & Lemley, *Technology-Specific*, *supra* note 525, at 1156 (emphasis added); *see also* Corrin Nicole Drakulich, Note, University of Rochester v. G.D. Searle & Co.*: In Search of a Written Description Standard*, 21 BERKELEY TECH. L.J. 11, 11 (2006) ("While patent law theoretically governs the validity of all patents in a technology-neutral manner, application of the rules has in fact varied among technologies.").

542. Burk & Lemley, *Technology-Specific*, *supra* note 525, at 1156; *see also supra* notes 155-59 and accompanying text (regarding Mr. Phosita's role in the patent system). Professors Burk and Lemley conclude that "the use of the PHOSITA [test] provides needed flexibility." Burk & Lemley, *Technology-Specific*, *supra* note 525, at 1157.

543. Burk & Lemley, *Technology-Specific*, *supra* note 525, at 1157.

> 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.[544]

i. Negative Consequences of a Technology-Specific Patent System

Professors Burk and Lemley list several potential negative consequences if Congress attempts to enact a different patent statute for each new field of technology. Some of the negative consequences include (i) the difficulty of creating a "statute to dictate in detail the right patent rules for each industry,"[545] (ii) the "substantial administrative costs and uncertaint[y]" involved in rewriting the patent law for each industry,[546] (iii) the uncertainty for practitioners and clients while waiting for interpretations of the new statute,[547] and (iv) the risk of "counterproductive special interest lobbying."[548]

ii. Benefits of a Simpler Statutory Scheme

An especially relevant consideration is confidence in the statutory provisions. The Internal Revenue Code is regularly ridiculed for its complexity, generating skepticism toward the U.S. tax system.[549] It may be

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544. Kuester & Thompson, *supra* note 113, at 673.

545. Burk & Lemley, *supra* note 202, at 1634.

546. *Id.* at 1635. The costs would include Congress writing new statutes, district court judges (as well as practitioners and clients) learning the new statute, and the uncertainty for practitioners and clients while they wait for interpretations of the new statute. *Id.*

547. *Id.*

548. *Id.* at 1637 ("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. Industry-specific legislation is much more vulnerable to industry capture. It is no accident that the industry-specific portions of the patent law are among the most complex and confusing sections, and that they have had some pernicious consequences." (footnote omitted)).

549. Yablon, *supra* note 1, at 104 ("'The term 'tax humor' is no doubt an oxymoron to many

argued that Congress should be hesitant to jeopardize the consistency of the patent statutes to accommodate the federal tax laws. As commentators have noted, industry-specific rules and exceptions can lead to a "bloated, impenetrable statute . . . like the tax code."[550] While a provision precluding tax strategies from patent protection, or restricting the rights associated with those patents, could be a minor amendment, it could encourage more technology-specific legislation.

4. Congress, the Treasury Department, and the IRS Can Change a Tax Law if They Dislike a Patented Tax Loophole

Tax planning strategies spring from tax statutes and other tax rules. While tax commentators debate whether taxpayers have a right to engage in tax planning,[551] they agree that Congress can amend a statute to eliminate a tax planning strategy.[552]

Similarly, after notice and comment, the Treasury Department can often adopt a regulation to close a loophole. For example, Lawrence Bell obtained a patent on a "tax-saving method involving deferred-compensation plans," but changes in the law "have made his strategy no longer 'an effective economic tool.'"[553]

Also, the IRS can simply issue a revenue ruling on its own initiative stating its view on a tax strategy.[554] For example, as discussed earlier, inventors submitted a series of patent applications for reverse split-dollar arrangements.[555] After a *New York Times* reporter published two front-page articles condemning the strategies,[556] the IRS issued Notice 2002-59 stating the IRS's view that the strategies did not work, and the Treasury Department subsequently issued final regulations adopting the IRS's approach.[557]

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people; to the more cynical, it is an apt description of the entire tax code.'" (quoting John F. Iekel)); *id.* at 107 ("'[The federal income tax system is] a disgrace to the human race.'" (quoting President Jimmy Carter)); *id.* ("'Everyone who has anything to do with the tax code agrees it's just an unbelievable mess.'" (quoting Paul H. O'Neill)); *id.* at 109 ("'All the Congress, all the accountants and the tax lawyers, all the judges, and a convention of wizards all cannot tell for sure what the income tax law says.'" (quoting Walter B. Wriston)); *id.* at 112 ("'I think our tax system is not worthy of an advanced society.'" (quoting Paul H. O'Neill)); *id.* ("'[The tax code] is a monstrosity . . . .'" (quoting Steve Forbes)); *id.* at 113 ("'Our tax code is so long it makes *War and Peace* seem breezy.'" (quoting Steven LaTourette)).

550. Burk & Lemley, *supra* note 202, at 1638.

551. *See supra* note 409.

552. *See supra* note 409.

553. Jacobs, *supra* note 4, at 44 (referring to U.S. Patent No. 6,609,111).

554. *See supra* note 275.

555. *See supra* note 474 and accompanying text.

556. *See supra* note 478 and accompanying text.

557. *See supra* notes 479-81 and accompanying text.

V. SUGGESTED APPROACH AND CONCLUSION: RESTRICT TAX LOOPHOLE PATENTS BY PROHIBITING THE COLLECTION OF DAMAGES BASED ON TAX SAVINGS AVAILABLE FROM USING A PATENTED INVENTION

In 1998, the Federal Circuit drastically relaxed the statutory subject matter requirement by declaring that a business method can be a patentable "process."[558] Tax loopholes, along with many other business methods, suddenly became patentable. The issue is whether the change to make tax loopholes patentable is beneficial.[559] This Article argues that the change is not beneficial, and that Congress should act, for three primary reasons. First, the utilitarian policy rationales that support patents in other industries do not apply to tax loopholes because more tax loopholes will not improve the general quality of life for the public, make the U.S. economy stronger, or improve the U.S. trade balance. Second, by granting tax patents, the Patent Office is frustrating the efforts of the Treasury Department, which has adopted regulations to reduce the economic incentive to invent and commercialize tax loopholes. Third, tax loophole patents violate the key tax principle of horizontal equity; in other words, similarly situated taxpayers will be treated differently because of these patents. Patenting of tax loopholes will make the tax world more complex and confusing for taxpayers, and taxpayers may become more cynical and less likely to voluntarily comply with the U.S. tax system in general.

Congress could prohibit the issuance of patents on tax-related inventions completely. In that case, patents would not be offered as an artificial inducement to encourage tax practitioners to invent loopholes. Initially, this appears to be an appropriate approach because there has been no troublesome shortage of tax loopholes in the past. However, an absolute prohibition on all tax-related inventions would have a few unfavorable consequences. Specifically, there are at least three types of tax-related inventions: 1) tax-compliance inventions, 2) incidental tax inventions, and 3) "pure" tax loophole inventions, but only the third is detrimental to society. The first type is beneficial, and the tax ramifications of the second are minor. Consequently, the third type of tax invention, i.e., the "pure" tax loophole invention, is the only target of this Article.

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558. *See* State St. Bank & Trust Co. v. Signature Fin. Group, Inc., 149 F.3d 1368, 1375 (Fed. Cir. 1998). The Federal Circuit likely would respond that the expansion was mandated by Congress in the Patent Act of 1952. *Id.* ("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.").

559. Other commentators would argue that the issue is whether different patent laws should be enacted for each industry, so that eventually the patent statute will be as complex as the Internal Revenue Code. *See supra* Part IV.C.3.

First, tax inventions that deal with tax compliance, tax bookkeeping, and tax preparation are not harmful to society. The IRS Commissioner has stated that these inventions can be beneficial in improving taxpayer compliance.[560] Thus, if Congress were to prohibit the issuance of patents on all tax-related inventions, these helpful tax compliance inventions would needlessly be lost in the process.

Second, a prohibition on all tax-related inventions would engulf inventions that have clear economic or business benefits that incorporate some minor tax feature or aspect. The invention considered in the *State Street Bank* case is an example. The invention considered in *State Street Bank* allowed multiple mutual funds to invest together, resulting in significant economies of scale.[561] A minor feature of the invention was that the business trust used to pool the investments would be taxed as a partnership for income tax purposes.[562] With regard to the non-tax aspects of these inventions, the arguments in this Article about tax loophole patents are inapplicable, and any tax advantages from these inventions appear merely incidental.

Third, there are the inventions that might be referred to as "pure" tax loophole patents. While it is a tax axiom that no strategy will be respected for tax purposes if it fails to have economic substance,[563] many effective tax strategies have little or no practical economic substance.[564] The policy arguments in this Article apply only to these inventions.

As a practical matter, inventions will likely fall all along a spectrum from pure tax loopholes with marginal economic substance, to true non-tax innovations that include an easily obtained tax feature that merely facilitates the non-tax benefits. As a result, hoping to find a perfect test or line-drawing approach, and expecting patent examiners to consistently apply that test on a case-by-case basis to patent applications, may be unrealistic.

Thus, rather than having Congress attempt to define and prohibit all pure tax loophole patents, Congress should prohibit the collection of damages from patent infringement based on tax savings. This would allow the Patent Office to analyze and issue tax-related patents without the need to weed out pure tax loophole patents. Tax advisors and taxpayers could

560. *Patenting of Tax Advice Hearings*, *supra* note 6 (statement of Mark Everson, Comm'r, IRS) ("[T]ax administration could in fact benefit from the granting of patents to tax products that facilitate the ability of taxpayers to plan and conduct their tax affairs in compliance with the law.").

561. *See supra* notes 67-69 and accompanying text.

562. *See supra* notes 67-70 and accompanying text.

563. BITTKER & LOKKEN, *supra* note 268, ¶ 4.3.3, pp. 4-34 and 4-35.

564. *See supra* notes 42-29 and accompanying text (regarding the *Riggs* case); *see also* Cottage Sav., Ass'n v. Comm'r, 499 U.S. 554, 567-68 (1991) (allowing a savings association to deduct losses resulting from "reciprocal sales" of depreciated mortgage loans to other institutions).

evaluate for themselves whether they will use the tax-related patent to realize tax savings or to obtain a non-tax economic advantage. Under such a new rule, if the taxpayer will enjoy no benefits other than tax savings from using the invention, the taxpayer could use the invention without fear of paying damages for infringement. On the other hand, if the taxpayer will enjoy non-tax economic benefits, the taxpayer may be required to pay damages for patent infringement, assuming the taxpayer uses the invention without obtaining a license. This approach is comparable to Congress's actions in dealing with patents on medical procedures. In that circumstance, rather than prohibiting patents in the area completely, Congress prohibited the patent-holder from collecting damages from health care practitioners and related entities for infringement of medical procedure patents.[565]

The availability of a patent provides tax gurus with an artificial economic incentive to invent and commercialize. Surely there is no need to give tax gurus further incentive to propagate an already abundant supply of tax loopholes.[566] The Treasury Department is reducing the incentives for developing and exploiting tax loopholes; the patent system should not be moving in the opposite direction. Consequently, Congress should prohibit the collection of damages based on tax savings available from using a patented invention. The Founding Fathers created a patent system to encourage inventions that would benefit society as a whole. Patented tax loopholes, however, will not benefit society as a whole, and Congress should not allow tax gurus to use the Patent Office as a tool to propagate tax injustice.

565. 35 U.S.C. § 287(c) (2000).
566. *See supra* Part. IV.A.2.