Tax Strategy Patents After the Leahy-Smith America Invents Act

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The Leahy-Smith Act deems tax strategies to be insufficiently novel and not obvious to differentiate an "invention" from prior art. On the face of it, tax strategy patents are no more. But nagging questions linger. And Congress did not disturb the more than 150 tax strategy patents in existence at the time the Act was passed. This article discusses the current state of the law, and its implications for practice.

Beginning at the End—You Can't Patent Tax Strategies Anymore

You can't patent a tax strategy anymore. Thanks for reading; now let's get back to arguing about what economic substance means. There's nothing to see here.

In all seriousness, even though purporting to "ban" tax strategy patents last September,[1] Congress left plenty for tax lawyers to think about. In patent law, an inventor can patent an invention only if it is novel and not obvious when compared against what patent lawyers call the "prior art."[2] And the Leahy-Smith Act tells inventors that they can't use a tax strategy to distinguish their claimed invention from the prior art. The invention must contain some other novel and non-obvious component that meets all the requirements for a patent. As we'll see, the way that Congress chose to stamp out tax strategy patents has real consequences—of course it does—and Congress had at least one other way to get rid of tax strategy patents that it chose not to use.

The point here is that there are still more than 150 tax strategy patents that are valid and enforceable. If you infringe one of them, the holder of the patent right can sue you. This article discusses how tax strategies ever got to be patentable in the first place, how they have been regulated, and how to

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[1] Leahy-Smith America Invents Act, P.L. 112-29, § 14 (Sept. 16, 2011) [hereinafter the "Leahy-Smith Act"].

[2] 35 U.S.C. § 102. An invention must also meet other requirements to be patented.

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answer the practical questions tax professionals still must face (even if we really, really don't want to be bothered with them).

Now that we've spoiled the ending, let's go back to the beginning.

Background—How Could You Patent Tax Strategies in the First Place?

Call to mind the classic image of the inventor tinkering in his garage. Odds are, you didn't picture him wearing a green eyeshade, pencil sharpened, desperately flipping through the Code and Treasury Regulations. Although tax strategy patents are somewhat new, their parent class of business method patents is not.

Business method patents have been granted from the earliest days of the U.S. patent system. Indeed, nothing in the U.S. patent statutes or in the Constitution would prevent business methods from being patented.[3] The cornerstone of the U.S. patent statute, 35 U.S.C. Section 101, specifically sets forth the type of inventions that can be patented: "[A]ny new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof."

However, courts began to hold that business methods were unpatentable. For example, in *Hotel Security Checking Co. v. Lorraine Co.*,[4] the Second Circuit held in 1908 that a system of accounts at a restaurant designed to keep the waitstaff from embezzling money was unpatentable. Similarly, in *Joseph E. Seagram & Sons v. Marzell*,[5] the D.C. Circuit held in 1950 that Seagram's couldn't patent the "method" of doing blind taste-tests for whiskey. Following the lead of these cases, the United States Patent and Trademark Office (USPTO) began to deny patents for business methods. It continued to do so until computers began to complicate matters, as they inevitably do. With examiners struggling to separate the patentable, technological components of an invention from the unpatentable business method components, the USPTO reversed its course and began to consider business method patents under the general patent requirements.[6] Then, in the early 1990s, the first tax strategy patents began to emerge.

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[3] 35 U.S.C. § 101 ("Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title."); U.S. Const. art. I, § 8, cl. 8 ("The Congress shall have power . . . To 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 . . . .").

[4] 160 F 467 (2d Cir. 1908).

[5] 180 F2d 26 (D.C. Cir. 1950).

[6] The Federal Circuit upheld this doctrinal shift after alleged infringers challenged it. See State St. Bank v. Signature Fin. Grp., 149 F3d 1368 (Fed. Cir. 1998); AT&T Corp. v. Excel Communic'ns, Inc., 172 F3d 1352 (Fed. Cir. 1999). In each case, the Federal Circuit held that business methods were not per se unpatentable.

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Existing Tax Strategy Patents

The USPTO classifies patents according to subject matter and has designated tax strategy patents as "705/36T." As of this writing, the USPTO has granted 174 patents classified as tax strategy patents.[7] As of September 2011, the USPTO was considering whether to approve about that many more patent applications.[8] The first tax strategy patent appears to be *Van Remortel et al.,* U.S. Patent 5,136,502, "System for funding, analyzing and managing health care liabilities."[9] Existing tax strategy patents range from the seemingly practical ("Systems and methods for safeguarding employee stock options from stock price fluctuations"[10]) to somewhat more obscure ("Shariah compliant private equity investment system"[11]).

Thus far, there is only one known infringement case involving a tax strategy patent: *Wealth Transfer Group, LLC v. Rowe,*[12] filed in 2007. It involved John Rowe, who was the CEO of Aetna Insurance. On the advice of his advisers, Mr. Rowe funded a grantor-retained annuity trust with nonqualified stock options to reduce his gift taxes. The arrangement was protected by a patent. At the time, practitioners knew about the patent, but apparently ignored it because the technique was so common.[13] Because Mr. Rowe was an insider at Aetna, Aetna had to disclose the arrangement in its securities filings. The patentholders discovered this and sued Mr. Rowe for infringement. The case was settled prior to trial. The parties stipulated that "there are facts from which a trier of fact could conclude that the [patent at issue] is not invalid and is not unenforceable."[14]

Balancing the Scales: Pros and Cons of Tax Strategy Patents

Tax strategies first drew the official attention of the IRS in 2004 and 2005, when the IRS collaborated with the USPTO, combing through existing tax strategy patents to determine whether any of them protected abusive tax

[7] The USPTO website allows searches based on patent classification. That search can be found at http://tinyurl.com/7zbj5gk.

[8] Similarly, here is a search for the tax strategy patent applications: http://tinyurl.com/dyl6akp.

[9] Available from Google Patents at http://www.google.com/patents?vid=5136502.

[10] Quinn et al., U. S. Patent 7,917,416, available from Google Patents at http://www.google.com/patents?vid=7917416.

[11] Barakat et al., U.S. Patent 8,032,433, available from Google Patents at http://www.google.com/patents?vid=8032433.

[12] 3:06CV00024 (D. Conn. 2007).

[13] Linda M. Beale, "Tax Patents: At the Crossroads of Tax and Patent Law," 2008 U. Ill. J.L. & Tech. Pol'y 107, 108 (2008).

[14] Consent Final Judgment Regarding Settlement Agreement, available at http://tinyurl.com/75fe;4w.

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avoidance transactions. The IRS ultimately determined that none did. Nevertheless, the IRS issued Proposed Regulations in 2007 that would have classified any transaction pertaining to a patented tax strategy as a "reportable transaction" subject to the rules for participants in reportable transactions and material advisors with respect to those transactions.[15]

These regulatory efforts were part of an increasing tide of criticism that came as tax strategy patents penetrated the public consciousness. Some arguments against patenting tax strategies are:

- Taxpayers might think that the IRS has blessed a patented strategy.
- Effective tax planning likely would become (even more) expensive and (even more) inefficient.
- It would make little sense for the federal government to encourage innovation by granting patents in a field the focus of which is depriving the federal government of revenue.
- USPTO examiners lack the experience to accurately compare a claimed new tax strategy against the "prior art" in tax law.

However, many of these and other criticisms of tax strategy patents could also apply to any patented invention. For example, the "lack of sophistication" argument could also apply to many of the highly technical inventions for which patents are granted routinely.

Although almost no one has spoken out in favor of tax strategy patents,[16] some of the policy arguments in favor of patents generally could also apply to tax strategy patents, namely:

- They would encourage and reward creative tax planning.
- They would encourage the spreading of tax knowledge by giving inventors an incentive to disclose innovative tax planning strategies that they might otherwise keep as a "trade secret" because an inventor must fully disclose how to use an invention; moreover, the IRS obviously would like to know the strategies that tax professionals are pursuing.
- Other tax lawyers and accountants would have an incentive to build upon and "design around" the existing patented tax strategies.

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[15] NPRM REG-129916-07 (Sept. 26, 2007); Prop. Treas. Reg. §§ 1.6011-4; 301.6111-3.

[16] One notable exception is Jacob Birnbaum, "Why the U.S. Congress Would Be Making a Colossal Mistake by Banning Tax Patents," 28(3) J. Tax'n Invs. 59 (Spring 2011); see also John R. Thomas, Congressional Research Service, "Patents on Tax Strategies: Issues in Intellectual Property and Innovation," 14-15 (Jan. 6, 2010), available at http://ipmall.info/hosted_resources/crs/RL34221_010610.pdf.

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However, the decisive argument against tax strategy patents is the following: Tax strategy patents would allow private persons to fence off areas of public legislation and to charge rent for other taxpayers to use them. As nice as it would be to charge fellow motorists for observing the speed limit, it's absurd.

Many critics of tax strategy patents hoped that the recent litigation in *Bilski v. Kappos*[17] would end them. In *Bilski*, the U.S. Supreme Court held that a business method for hedging a portfolio of investments in the energy industry could not be patented. But the majority stopped short of holding that business methods were unpatentable. Nevertheless, in a concurring opinion, Justice Stevens opined that business methods should be treated as per se unpatentable. Justices Ginsburg, Breyer, and Sotomayor joined the opinion. So the Supreme Court was one vote away from holding that business methods were per se unpatentable. Although many speculated that the *Bilski* litigation would end business method patents,[18] sweeping away tax strategy patents in the process, business method patents are here to stay—for now. With business method patents still safe after *Bilski*, Congress or the Supreme Court would have to act to invalidate tax strategy patents.

The Leahy-Smith Act

After debating bills to bar tax strategy patents for months, Congress finally agreed on the Leahy-Smith Act,[19] and President Obama signed it into law on September 16, 2011.[20] Leahy-Smith Act Section 14 deems "tax strategies" to fail the requirements that a claimed invention be novel and not obvious.[21] The Act defines a "tax strategy" as "any strategy for reducing, avoiding, or deferring tax liability.[22] A "tax liability" includes a federal, state, or local tax liability.[23] There are two exceptions:

[17] 130 S. Ct. 3218 (2010). For a good general discussion, see CRS Report, *Patents on Tax Strategies: Issues in Intellectual Property and Innovation* (Oct. 25, 2007), available at http://taxprof.typepad.com/taxprof_blog/files/crs_342211.pdf, and the materials cited therein; Dan L. Burk & Brett H. McDonnell, "Patents, Tax Strategies, and the Firm," 26 Va. Tax Rev. 981 (2007).

[18] See, e.g., Ebby Abraham, "*Bilski v. Kappos:* Sideline Analysis From the First Inning of Play," 26 Berkeley Tech. L.J. 15 (2011).

[19] The Senate passed S. 23 on March 8, 2011, by a 95-5 vote; the House passed H.R. 1249 on June 23, 2011, by a 304-117 vote; and the Senate passed H.R. 1249 on September 8, 2011, by an 89-9 vote.

[20] The main reform of the Act was to shift the U.S. from a "first to invent" system to a "first to file" system for patent applications filed on or after March 16, 2013. That is, patents granted after that date will be awarded to the inventor who wins the "race to the patent office" even if some poor soul has already invented the claimed invention.

[21] See also USPTO Memorandum, "*Tax Strategies*" *Are Deemed to Be Within the Prior Art*, available at http://www.uspto.gov/aia_implementation/tax-strategies-memo.pdf.

[22] Leahy-Smith Act § 14(c)(1).

[23] Leahy-Smith Act § 14(c)(2).

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1. *The so-called "TurboTax" exception:* "[A] method, apparatus, technology, computer program, product, or system, that is used solely for preparing a tax or information return or other tax filing, including one that records, transmits, transfers, or organizes data related to such filing," is not per se non-novel and non-obvious.
2. *The "Financial Management" exception:* "[A] method, apparatus, technology, computer program product, or system used solely for financial management, to the extent that it is severable from any tax strategy or does not limit the use of any tax strategy by any taxpayer or tax advisor," likewise is not per se non-novel and non-obvious.

Let's stop for a moment and consider a point we brought up at the outset: Congress could have carved out tax strategies from the list of patentable subject matter in 35 U.S.C. Section 101. Instead, it chose to target tax strategy patents through the novelty and non-obviousness requirements in 35 U.S.C. Section 102. It is dangerous to speculate about what Congress was "thinking" when passing a law. But the legislators might have been concerned that a subject matter ban could have blocked a legitimate patent simply because it contained tax-related claims. For example, an inventor likely can still patent a novel computer program or novel computer hardware that meets all other patent requirements, even if a portion of the claimed invention contains tax-strategy aspects. The Leahy-Smith Act prevents the inventor from relying solely on the tax-related claims to make the invention novel and non-obvious.

The Leahy-Smith Act applies to "any patent application that is pending on, or filed on or after" September 16, 2011.[24] This means that patent applications that were under review by a patent examiner at the time of enactment are subject to the new rules. The Leahy-Smith Act also applies to "any patent that is issued on or after" September 16, 2011.[25] This is relevant for "reexaminations" or other post-grant proceedings. An alleged infringer can respond to a claim of infringement by demonstrating that the patent he is alleged to have infringed satisfies the novelty and nonobviousness requirements solely because of a tax strategy, thus invalidating the patent.

Practice Implications

The bottom line is this: The tax strategy patents that existed on September 16, 2011, are still valid. If you infringe them, you're liable. That said, there are a few things to consider:

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[24] Leahy-Smith Act § 14(e).

[25] Id. USPTO Memorandum, supra note 21.

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- *It might not be just the tax strategy patents that existed on September 16, 2011, that we need to worry about.* As discussed above, the "ban" on tax strategy patents might not be a ban at all. From the Leahy-Smith Act's language, it seems that intrepid inventors could circumvent the act's requirements by pinning a tax strategy onto otherwise patentable matters (e.g., computer software or hardware). The statute blocks only those patent claims that would not be novel or non-obvious "but for" a tax strategy.
- *Even if you're caught infringing a tax strategy patent, there are steps you can take.* The Leahy-Smith Act strengthens the procedures that alleged infringers can use to attack an existing patent, particularly as to business method patents.[26] Although tax strategy patents may be more amenable to these sorts of "collateral attacks," these post-grant review procedures also require a hefty fee. In addition, collateral attacks can impose significant evidentiary burdens. An alleged infringer who attacks a tax strategy patent on the grounds that it is not novel must provide documentation of previous use of the strategy to prove that the state of the prior art encompassed the claimed invention.[27] This can be demonstrated by proving that the claimed tax strategy invention was being used in practice prior to the date on which the inventor claimed to have "invented" it. So check your files.
- *Given all of that, the question practitioners should be asking themselves is this: When should I do a search of existing tax strategy patents?* I hate to say it, but the answer, at least the abstract answer, is "always." Now, as a practical matter, there are a number of considerations that reduce this burden. There is the threshold question of whether the infringement will ever be discovered. Unless your clients are in Mr. Rowe's situation—having to disclose tax strategies in a securities disclosure—it seems unlikely that a tax strategy patent holder will discover the infringement. (I say this with all due respect to readers who hold tax strategy patents.) Practitioners should take a reasoned approach: the more novel and highly structured a planning technique is, the more likely it is to be protected by a patent. It probably does not make sense to invest time researching existing tax strategy patents for a garden variety asset sale. (Although it is beyond the scope of this article, one useful project for a tax

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[26] See, e.g., Leahy-Smith Act § 18.

[27] If you feel like doing a good turn for your fellow tax lawyer, the Leahy-Smith Act provides an opportunity. It adds new 35 U.S.C. § 301, which provides: "Any person at any time may cite to the [USPTO] in writing—(1) prior art consisting of patents or printed publications which [sic] that person believes to have a bearing on patentability of any claim of a particular patent."

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practitioner with extra time on his hands would be a quick reference guide of the existing tax strategy patents that allows for keyword searching.[28] The USPTO website is cumbersome to work with.)

Conclusion

In all practicality, Congress has ended tax strategy patents. But as with any congressional attempt to end a particular practice, there will be lingering issues. Existing tax strategy patents are still valid, and the holders of the rights associated with those patents can enforce them. The existing tax strategy patents further complicate the tax practitioner's busy world. The best approach for us to take is, as always, a reasonable one—patent searches probably make little sense in the regular course of tax practice. But for any new, highly structured transaction, the best approach is to spend a few minutes with the USPTO.

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[28] Birnbaum provides a useful classification of the subjects and topics of 705/36T patents issued as of early 2011, Birnbaum, supra note 16, at 72 (Exhibit 1), and provides a summary of 20 patents recently granted under that classification. Id. at 82 (Appendix A).