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IP

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Whose Tax Law Is It?

Alarm bells should ring over rising efforts to patent tax strategies.

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Can you patent a method of complying with the law? If the law is the Internal Revenue Code, the surprising answer is yes.

In the wake of a still-controversial 1998 decision by the U.S. Court of Appeals for the Federal Circuit, a new flood of government-sanctioned monopolies—otherwise known as "business method" patents—has invaded our economy. Few of these patents are more disturbing than those that claim tax strategies.

The U.S. Patent and Trademark Office recently reported that 41 business-method patents covering tax strategies have been issued and that applications are pending for another 61 patents. Last January a suit for infringement of a tax-strategy patent was filed in federal court in Connecticut. And in July 2006, a House Ways and Means subcommittee held a hearing to address the impact of these patents. The Internal Revenue Service and the Patent Office gave testimony.

Tax practitioners are sounding the alarm. They are dismayed at the new need to limit their counsel so they and their clients are not sued for infringement. And they realize they face a Hobson's choice: Either pay tribute to the patent owner or lose certain advantages under the tax laws.

That is, if even the Hobson's choice exists. Because patent holders are not required to license their intellectual property, a valuable tax strategy may be simply unusable for the life of the patent.

Lawyers can't stick their heads in the sand on this problem. Tax practitioners must learn how patent law works so they can, at least, minimize the disruptive effects of patents covering tax strategies. And patent lawyers should help out in this critical debate over what should and should not be patentable.

The problem began in 1998. Before then, inventors and patent lawyers generally recognized the exception to the patent laws that excluded protection for methods of doing business.

It's true that the law didn't state this explicitly. Under its constitutional authority to "promote the Progress of Science and useful Arts," Congress enacted 35 U.S.C. §101, which provides that whoever invents a "new and useful process" may obtain a patent. And in *Diamond v. Chakrabarty* (1980), a case involving a bacterium that could break down crude oil, the Supreme Court interpreted §101 so broadly as to cover "anything under the sun that is made by man."

But the judicial limitations on what is patentable have tra-

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ditionally been understood to exclude "laws of nature, natural phenomena and abstract ideas" (to quote the Supreme Court, this time in 1981's *Diamond v. Diehr*). For example, mathematical algorithms in their abstract form are not patentable, but they can be protected once they are incorporated into a practical or "concrete" application.

In *State Street Bank & Trust Co. v. Signature Financial Group* (1998), the Federal Circuit allowed patent protection for an investment-data processing system and thereby laid to rest the previous hesitation to patent business methods—an "ill-conceived notion," the court said. Applications for business-method patents took off.

More recently, the judiciary has shown signs of questioning the wisdom of *State Street*. The most telling comments may have come in the Supreme Court's June 2006 decision to dismiss *Laboratory Corp. of America v. Metabolite Laboratories* as improvidently granted. Justice Stephen Breyer, writing in dissent, explicitly singled out the Federal Circuit's statement in *State Street* that "a process is patentable if it produces a 'useful, concrete, and tangible result.' " Breyer wrote that the Supreme Court had "never made such a statement and, if taken literally, the statement would cover instances where this Court has held the contrary."

In May 2006, Justice Anthony Kennedy also addressed the business-method patent issue, albeit from the viewpoint of injunctive relief. In his concurring opinion in *eBay Inc. v. MercExchange LLC,* he made the following rather unflattering statement:

"In addition, injunctive relief may have different consequences for the burgeoning number of patents over business methods, which were not of much economic and legal significance in earlier times. The potential vagueness and suspect validity of some of these patents may affect the calculus under the four-factor test."

If the Supreme Court raises such questions about business-method patents in general, how much more concerned will it be about restrictions on the ability of American citizens to take full advantage of the tax law? Given the opportunity to rule on the issue, how would the Supreme Court view patents that limit otherwise appropriate tax advice, restrict taxpayers' ability to obtain legitimate tax benefits, and result in the unequal treatment of similarly situated taxpayers?

espite their appropriate concerns, unless the right case to challenge the *State Street* holding comes before them, the real solution to the tax-strategy patent problem does not lie with the justices—nor, for that matter, with the Patent Office.

In a written statement presented to the House Ways and Means Subcommittee on Select Revenue Measures in July, James Toupin, general counsel of the Patent Office, reminded lawmakers that the definition of "patentable subject matter" begins with legislation. The Patent Office is obligated to follow the law as written by Congress and interpreted by the judiciary.

Generally speaking, a patent will be issued if there is a preponderance of evidence that the applicant has complied with the statutes and rules, including §101. Once a patent has been issued, the Patent Office has limited jurisdiction to revoke or invalidate it. If the courts deem business methods to be patentable subject matter and Congress does not object, the Patent Office is in no position to refuse to examine such applications, regardless of its own views on the issue.

Removing subject matter from the patenting process is not unheard of. Congress has done it before. In 1954, for example, lawmakers created an "exception" to §101 by enacting 42 U.S.C. §2181, which bars patent protection for inventions that are "useful solely in the utilization of special nuclear material or atomic energy in an atomic weapon."

In lieu of carving out whole subject-matter areas as unpatentable, Congress has addressed some concerns by limiting the remedies available to patent holders. For example, patent holders are ordinarily entitled by statute to receive lost profits or reasonable royalties from an infringer, and they may request an injunction to halt the infringing activity. But in the wake of a series of controversial patents covering certain surgical procedures, Congress enacted 35 U.S.C. §287(c)(1). This 1996 provision bars patent holders from obtaining remedies, including damages and injunctions, against "medical practitioners" based on patents for medical or surgical procedures.

Finally, in the wake of the *State Street* decision, Congress provided a limited "prior user" defense at 35 U.S.C. §273(b)(1) as part of the American Inventors Protection Act of 1999. The defense is available only to those accused of infringing business-method patents who both had reduced the subject matter to practice at least one year before the effective filing date of the patent and had commercially used that subject matter before the filing date.

On the other hand, although these exceptions demonstrate some flexibility, Congress' ability to rewrite the patent laws is not without constraint. In the 1990s the United States, in attempting to harmonize patent laws worldwide, entered into a series of trade agreements with foreign governments. The agreements define the range of patentable subject matter and the protection to which it is entitled.

But as Congress reviews what it can and cannot do in light of U.S. treaty obligations, and as the judiciary works to variously unravel, clarify, or reconcile its decisions, the Patent Office continues to issue patents for tax strategies. And tax practitioners worry about what this development means for their work.

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Their core objection is that patents on tax strategies contradict one of the fundamental tenets of the federal tax system, that similarly situated taxpayers should be treated the same, a tenet set forth by the Court of Claims in *IBM Corp. v. United States* (1965).

When enacting the various provisions of the Internal Revenue Code, Congress surely never intended certain aspects of the tax law to be fenced off later from many or most taxpayers in the class addressed by the legislation. Lawmakers surely did not expect this fencing to proceed with government-issued barbed wire. Indeed, the successful patenting of tax strategies now limits Congress' ability to shape economic policy through legislation and places that power in the hands of individual patent holders.

These patents also have the potential to unfairly skew the marketplace. Imagine that a single company in a competitive industry devises a highly effective tax strategy (i.e., one that results in the company paying less to the government today or sometime down the road). That company is under no obligation to share its idea with its rivals, but other companies are equally free to use the same strategy if they learn about the first company's idea or develop it themselves.

Now imagine what happens if the first company patents its tax strategy: That company can refuse to license the patent to its competitors. For the 20-year life of that patent, the company can realize a substantial advantage from simultaneously using the tax strategy itself and placing it off-limits to others.

This economic advantage flows not from providing better goods and services, or from finding a more efficient way of providing goods and services, but from developing a better way to secure tax benefits from the government. There is arguably no "useful, concrete, and tangible result" to be found in a single business securing a tax advantage.

Not unlike the doctors who wanted to restrict patents on surgical procedures, tax advisers have numerous practical concerns with business-method patents, as well. To begin with, there are the additional costs of trying to avoid recommendations that would cause a client to infringe upon existing patents. Making sure not to emulate other people's good ideas is not how tax practitioners traditionally go about their work.

Another worry arises if the patent covers not only the method of creating a tax-advantaged structure but also the method of unwinding it. One way or the other, courts could find themselves unable to order relief that doesn't infringe.

A more fundamental concern is that patents have been and will be issued for tax strategies that are not truly novel or nonobvious as required by the patent laws. The problem of determining novelty and nonobviousness is particularly acute in the realm of tax strategies. Much of what might otherwise constitute prior art is protected by the attorney-client privilege, the tax-practitioner privilege created by the Internal Revenue Code, and the taxpayer privacy provisions of the Internal Revenue Code. Many aspects of the prior art would qualify as public (and therefore assertable against a claim for a patent) if not for the fact that tax advisers typically work on a confidential basis, with that confidentiality being protected by the Internal Revenue Code itself.

In short, the Patent Office possesses neither sufficient information about the prior art that exists in the field nor the tax expertise required to determine, from that prior art, whether a particular tax strategy is novel or nonobvious to the (hypothetical) tax practitioner with average skill in the field.

Finally, tax advisers (at least those who are lawyers) wonder what is to prevent other types of legal strategies—say, a novel and nonobvious strategy for obtaining recovery from a deep-pocketed defendant in a class action—from also being patented as business methods? Historically, the domain of the law has been viewed as an "open range" that should not be fenced off into private domains. Most lawyers would contend that no one should be permitted to effectively own aspects of the law.

So what can be done about business-method patents on tax strategies? There are at least five potential fronts, all of which are worth engaging.

First, U.S. and foreign governments must be educated about the problems posed by tax-strategy patents not only for U.S. tax practitioners but also for tax practitioners around the world. Treaties must be examined, and future actions reconciled with those treaties.

Second, Congress should be encouraged to grant focused relief. Tax practitioners should help lawmakers to understand that tax-strategy patents impinge in a fundamental way upon Congress' ability to shape economic policy.

Lawmakers have two main options. They can provide a

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specific exemption, such as that given to atomic weapons, or they can limit available remedies by, for example, precluding injunctive relief.

Tax practitioners can also assist in the creation of prior art when Congress drafts tax legislation. Potential tax strategies can be described in the legislative history, so that a record of prior art is created, and subsequent patents claiming a disclosed strategy (or something obvious in light of a disclosed strategy) are less likely to issue.

Third, tax practitioners need to formulate a litigation strategy consistent with their client responsibilities. Specifically, they should work with patent counsel to identify and advance cases in which the judiciary will have the chance to modify, clarify, or narrow the *State Street* decision.

Fourth, tax practitioners should engage the Patent Office. It's time to help that office build up a comprehensive archive of tax materials.

Perhaps the Patent Office can also be encouraged to adopt special procedures for dealing with patent applications that involve tax law. As scientifically trained patent examiners are ill equipped to address this subject matter, the office might hire experienced tax attorneys to examine claims on tax-planning methods so that, to the extent it is presented, patentable subject matter can be fairly reviewed.

Finally, tax practitioners can take steps to make it more difficult for particular pending applications to result in patents. Applications are usually made public 18 months after they are filed. If tax practitioners become aware of an attempt to patent a tax strategy that is not novel or nonobvious, they can gather the relevant prior art and promptly (within two months of the application's publication date) submit that prior art to the Patent Office or (if later) directly to the applicant. If the applicant then withholds such prior art from the examiner, any patent that issues may later be declared unenforceable.

Whatever tax practitioners individually choose to do, they ought not be complacent about the threat of tax-strategy patents. For the most part, vigorous efforts to patent new ideas are good for this country. But not always and, from the tax practitioner's perspective, not when the ability of American taxpayers to fully benefit from the tax law is at stake.

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