

# United States

## Tax strategists discover US business method patents

The US Patent and Trademark Office (USPTO) has begun to issue patents covering methods for reducing tax liability under the US Internal Revenue Code, and to date at least one lawsuit has been filed to enforce such a patent. Taxpayers and tax advisers who have long relied on a culture of sharing tax reduction strategies find themselves in the same position as their counterparts in e-commerce and the financial industries before them – having to deal with possible patents on their methods of doing business.

This chapter examines the risks and opportunities provided by tax-related business method patents, some of the issues raised as these patents draw public attention and whether the United States is likely to ban such patents as contrary to public policy.

### Business method patents in the tax arena

Can a person or firm with a new and sufficiently creative approach to tax planning choose to ignore a well-established business culture by claiming exclusive rights for intellectual capital? It has happened before in other fields and it is increasingly common in the field of tax planning. Barring action by Congress, taxpayers and tax planners have little choice but to take care not to infringe patents granted on new tax reduction strategies. However, the nature of tax planning may insulate the field from radical change. A tax planner who seeks a reliable, well-established strategy for clients tends to avoid new, untested theories. Still, some will choose to take advantage of the new business method patent tools to seek a competitive advantage by devising new tax strategies and protecting them by patents.

The Alston & Bird LLP chapter of *IP Value 2006* suggested that seeking to comply efficiently with government regulations stimulates innovation and the filing of business method patents (eg, a taxpayer's need to comply with government tax rules at the lowest legitimate cost to the taxpayer). Thus, the filing and

enforcement of patents on tax reduction strategies is unsurprising. However, such patents have stimulated considerable controversy in the United States. In fact, in July 2006 the Subcommittee on Select Revenue Measures of the US House Committee on Ways and Means held hearings on "issues relating to the patenting of tax advice". The subcommittee heard a wide variety of views from the USPTO, the Internal Revenue Service (IRS), law professors and tax advisers.

The witnesses focused considerable attention on a granted US patent (6,567,790) for minimising transfer tax liability when transferring non-qualified stock options to a family member (the Stock Options Grantor Retained Annuity Trust (SOG RAT) patent). The owner of the patent, Wealth Transfer Group LLC, has filed suit in the Connecticut federal district courts against John W Rowe, executive chairman of Aetna Inc. The case is in its early stages, with discovery still in progress at the time of writing. To prove that Rowe infringed the patent, Wealth Transfer Group will have to prove that it carried out the steps required by the patent using a computer for at least part of the method. The judge will interpret the claims to define the proof required, but generally the claims require:

- the funding of a grantor-retained annuity trust (GRAT) with stock options that have a determined value;
- establishment of a term for the trust and a schedule for annuity payments to be made from the trust;
- valuation of the stock options as each annuity payment is made; and
- determination of how many stock options should be included in the annuity payment.

### Tax strategy inventions must pass muster

Should this type of invention be patented? One must first distinguish between criticism that a particular concept is obvious and criticism that an entire class of inventions

should not be patented for public policy reasons. Some tax practitioners may have been publicly funding GRAT trusts with stock options prior to December 1 1998, and if they present proof the patent may be invalid. Even if the practice was not known early enough to count against the patent, the SOGRAT invention has been criticised as unpatentable because it would have been obvious to fund a GRAT with any type of asset, including stock options. The inventor approached the issue from the other direction, arguing that taxpayers faced an unsolved problem in the form of transfer taxes when transferring non-qualified stock options to family members, and that placing the options in a GRAT was a non-obvious solution to the problem. The patent examiner, given the knowledge of prior practices available to the USPTO at the time, accepted the inventor's point of view, allowing the claims without any rejection of prior art. Although the SOGRAT patent is likely to be challenged in the courts – probably by the defendant in the current litigation – an argument that this patent is invalid does not reflect on other business method patents for tax reduction methods.

Not only are individual patents subject to invalidity challenges, but also their influence is restricted to the coverage defined by the claims of the patent. For example, the SOGRAT patent claims require that at least part of the method be performed by a signal processing device (eg, a computer). The influence of a business method patent is also limited by statutory prior use rights particular to business method inventions. Generally a party which completed the infringing subject matter at least one year before the new patent's filing date and commercially used the subject matter before that date may assert a defence to a charge of infringement of that patent.

#### **USPTO position**

The USPTO has taken a liberal position with regard to giving business method concepts consideration equal to other inventions. The United States, as a leader in IP protection, strongly supports patent protection for most subject matter. The USPTO is unlikely to forgo the advantage that this policy gives to US patent holders. In contrast to innovators in other countries, US patent owners are able to prevent competitors who learn of a business process from freely using the information to compete in the United States for the term of the patent. James A Toupin, USPTO general counsel, testified at the July 2006 hearing on the statutory and case law basis underlying the USPTO's position that it should examine and issue qualified business method patents for tax strategies. The USPTO has established a subject

classification (706/36T) for tax strategies. However, Toupin also described special efforts to ensure that the USPTO has the best resources available to avoid issuing patents for concepts that are obvious, well known or in public use.

It would not be unusual for the USPTO to lack resources in an area newly opened to patenting. This issue led to a number of patents on converting known processes for the Internet when the patent applications should have been rejected as obvious. The USPTO is now working with the IRS to expand its knowledge of known tax strategies.

Many other countries have laws or regulations barring patents on methods of doing business. Patents on tax reduction strategies would generally not be granted in such countries. However, computer systems relating to tax processing and tax planning may meet requirements for patenting.

#### **Examining the case against patenting tax strategies**

Turning back to the debate over US law and policy, here are some examples of the arguments made at the hearing for denying protection to patents for tax reduction strategies.

#### **Tax strategy patents are against public policy**

Tax planners do not have a strong argument that patents on tax strategies should be banned as being against public policy. Many areas that affect the public good more directly can be patented (eg, medicines, pollution control devices). The public policy argument against patents for tax strategies is actually an argument against all business method patents.

#### **Such patents will legitimise abusive tax strategies**

Tax strategy patents will not undermine efforts to collect tax revenue. IRS Commissioner Mark Everson testified that the agency examined patents for tax strategies and did not find a problem with inventors patenting illegal or abusive tax strategies. In any case, patents do not give the patent owner a licence to practise the invention if it is subject to laws making the practice illegal or to superior patent rights. Patents allow the holder to control use of covered methods during the patent term, rather than opening them up for unrestricted use.

#### **Such patents will have a negative impact on taxpayers' ability to comply with tax laws**

Everson stated his concern that granting patent protection to tax strategies "could limit the use of that particular strategy by other taxpayers and have a negative impact on their ability to comply with the tax

law". This issue would be highlighted if a patented tax strategy were adopted by the IRS as a mandatory method or a safe harbour, or written into the Tax Code when defining the amount of tax due under the relevant circumstances. The IRS should attempt to make required practices non-infringing or obtain an agreement from the patent owner to grant licences on a reasonable and non-discriminatory basis.

#### **Such patents place an undue burden on tax advisers**

Everson pointed out the increased burden entailed if tax practitioners have to conduct patent searches before recommending a tax reduction strategy. The weight of this burden depends on how often a patent search is needed. Some tax planners favour well-established, rather than innovative, strategies for their clients. No valid patent can be obtained for a strategy that has been published, sold or publicly used more than a year before the patent's filing date, or was known by others before the current inventor's conception of the idea. On the other hand, patent applications are often pending in the USPTO for several years, so a practice that has been used for years may not pre-date the patent.

Patent infringement risk is a part of virtually every transaction in which one party supplies products or services to another. That risk has grown as companies recognise the value of their intellectual property. It has also grown in industries such as software and financial services as inventors in those fields have sought patents more frequently.

Moreover, lawyers and other tax advisers often present various available courses of action to their clients and discuss what steps could be taken to evaluate the risks associated with each path. Clients do not always wish to take every step available to determine or reduce the possible risks. No doubt tax advisers will not be authorised to carry out a patent search for each tax strategy they recommend.

Tax advisers should notify their clients that patent infringement is a risk of implementing tax strategies, and avoid creating the impression that a recommendation is free of risk. Just as a change in the tax law may affect the desirability of a tax strategy, so may the emergence of a relevant patent. Not all patent risks can be predicted by a search. For example, patents may issue after the search is completed, covering a tax strategy that has been implemented by a taxpayer before the issue date of the patent.

There are circumstances in which a 'freedom to operate' patent search makes sense. If the potential for a large damage award is high in light of the amount of tax savings at stake, a search may be warranted. If the tax

strategy involves significant changes in the manner in which a taxpayer does business or a significant investment in equipment, infrastructure or staffing, a cost-benefit analysis may indicate it is worthwhile to assess the risk of encountering an allegation of patent infringement.

In industries in which patents are more established, the parties to a supply transaction often determine who will bear the risk of unknown patents. For example, a supplier of pollution control equipment may provide an indemnity against infringement to its customer. However, the supplier may expressly disclaim liability for patent infringement resulting from use of the equipment. Patents grant the exclusive right to make, use and sell the invention and protect against the inducement of infringement. Thus, both taxpayers and tax advisers face a risk of being charged with infringement.

#### **Such patents damage the tax system**

Everson's remarks suggest that the IRS needs good ideas from tax practitioners to help it implement the tangled thicket of tax laws passed by Congress. Professor Ellen Aprill testified that tax strategy patents affect professional culture, and that the tax system will suffer if tax professionals are no longer willing to discuss, evaluate and criticise each other's insights regarding how to comply with the tax system. She pointed out that the tax system itself provides plenty of economic incentive for taxpayers and tax advisers to find legitimate ways to reduce taxes. On the other hand, Professor Richard S Gruner testified that patents on tax planning methods, while highly foreign and seemingly dysfunctional to tax planners at present, may ultimately be beneficial to this field because they spur innovation as tax planning methods move towards sophisticated, computer-intensive means of asset and income management.

#### **Opportunities**

Gruner pointed out that inventors may obtain a justified advantage over competitors by obtaining patent protection. Rather than fighting patents for tax strategies, some tax advisers will make serious efforts to conceive their own innovations which they can patent and market to clients as exclusively available from the patent owner. As business method patents take hold in all industries, the function of new product development is perceived more as a traditional research and development function that is expected to generate intellectual property.

On the marketing side, some tax advisers may conduct freedom to operate searches for a portfolio of tax strategies in order to market them to clients and potential clients, accompanied by a patent risk analysis. Providing a patent indemnity is a bigger step – and one which

seems unlikely to become common unless clients have the leverage to demand it.

#### Role of Congress

At present, it seems unlikely that Congress will exempt the tax planning field from the realm of patentable subject matter. The United States has accepted business method patents under a philosophy that applies to tax strategies. Perhaps legislation will be proposed to permit compulsory licences for tax strategy patents. The outcome may depend on the persuasiveness of legislative advocates who are known for their experience in shaping legislation relating to taxes. However, the United States rarely forces patent owners to grant licences.

#### Conclusion

The concerns raised about tax strategy patents are not unique to the field of tax planning. Like participants in other fields where business method patents have altered the competitive landscape, taxpayers and tax advisers are experiencing a shift in how they approach the risks of implementing selected tax strategies. Patents will play a role in the industry, but the significance of that role is yet to be determined. As the playing field evolves, tax planners should take care to manage expectations associated with the level of risk of adopting particular tax strategies. Some will pursue the opportunities presented to take commercial advantage of patents granted for their inventions. Patents for tax planning strategies seem here to stay.

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