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New York State Bar Association

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August 17, 2006

The Honorable William M. Thomas
Chairman
House Committee on Ways and Means
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Washington, DC 20515

The Honorable Charles B. Rangel
Ranking Member
House Committee on Ways and Means
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Washington, DC 20515

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
135 Hart Senate Office Building
Washington, DC 20510

The Honorable Max S. Baucus
Ranking Member
Senate Committee on Finance
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The Honorable David Camp
Chairman
House Committee on Ways and Means,
Subcommittee on Select Revenue Measures
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Washington, D.C. 20515

The Honorable Michael R. McNulty
Ranking Member
House Committee on Ways and Means,
Subcommittee on Select Revenue Measures
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Washington, DC 20515

Re: Patentability of Tax Advice and Tax Strategies

Dear Sirs:

I am writing on behalf of the Tax Section of the New York State Bar Association[1] to express our views on the subject of the patentability of tax advice and tax strategies. This issue was addressed at a public hearing on July 13, 2006 before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means.[2]

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1 This letter was drafted by Kimberly Blanchard and Andrew Braiterman, based on input from the members of the Executive Committee of the Tax Section.

2 The staff of the Joint Committee on Taxation prepared an excellent overview of the issues. Join Committee on Taxation, *Background and Issues Relating to the Patenting of Tax Advice* (JCX-31-06), July 12, 2006.

Scope of Comments

As tax lawyers, we do not profess any expertise in the area of patent law. We also recognize that tax-related patents pose many similar issues to those posed by patents in other areas relating to business processes and financial products. Accordingly, we are not writing to express any view as to the permissibility or validity of tax-related patents under current patent law or to suggest specific changes in the patent law. The purpose of this letter is to state our views, based upon our experience as tax lawyers, on the impact that patenting tax advice and tax strategies might have on the integrity and administration of the tax laws, on taxpayers, and on us as tax practitioners.

Our comments are limited to patents on tax advice and tax strategies, by which we mean interpretations of the tax law as well as the application of tax principles and laws to structuring transactions, business entities, and the ownership of property. We are experienced in rendering tax advice; most of us have no experience in preparing tax returns (other than our own). This letter is not intended to address the effect of patent (or copyright) protection for tax preparation software and other mechanical tools for easing taxpayers' compliance with the tax laws. [3]

Summary of the Tax Section's Views

We think the patenting of tax advice and tax strategies raises a number of difficult policy and practical issues. While the payment of taxes is mandatory, taxpayers are free to arrange their affairs within the bounds of the law in a manner that minimizes their legal liability for taxes. We do not believe that it is sound policy to force taxpayers to choose between paying more tax than they are legally obligated to pay and paying royalties to a third party who has patented a tax strategy.

In addition to this basic policy concern, we believe that applying patent law to tax strategies poses serious administrative problems and burdens, on account of the manner in which tax strategies are developed, the confidential nature of tax returns and the relationships between tax practitioners and their clients. These problems include difficulties in establishing and challenging the originality and obviousness of tax strategies, as well as issues in identifying what types of behavior constitute infringement. We believe that allowing tax strategies to be patented may interfere with the duties that tax practitioners owe to their clients, as well as the free exchange of ideas among tax practitioners and between tax practitioners and government officials, resulting in adverse effects on taxpayers and tax practitioners and ultimately on the development of sound tax policy.

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[3] Although it may be difficult to describe in words the distinction between tax planning advice and tax compliance advice, we do believe that such a distinction exists and in most cases is readily apparent. As a general rule, computer software programs that enable complex mathematical calculations to be modeled, such as tracking ownership changes under section 382 of the Code, tracking qualified production activities income under section 199 of the Code, or calculating foreign tax credit ratios, would not be implicated by our remarks in this letter.

Nature of Tax Strategies

In order to address the impact of granting patent protection for tax strategies, it is important to consider the types of strategies that are developed by tax practitioners and employed by taxpayers. Tax strategies range from benign structures that are clearly consistent with the tax law, to mildly aggressive transactions of uncertain validity, to flagrantly abusive transactions that arguably comply with the technical requirements of the tax law but produce results that clearly were never intended by Congress.

Typical types of tax strategies include the following:

1. An individual taxpayer may transfer assets to a trust with provisions that are intended to minimize income, estate, and/or gift tax liabilities.[4]

2. Mergers, acquisitions, joint ventures and financing transactions, which are carried out for non-tax related business reasons, are commonly structured in a manner intended to minimize the parties' tax liabilities, for example by complying with the detailed rules applicable to tax-free reorganizations and exchanges.

3. Business entities may be capitalized with equity, debt or a combination of the two, and may take the form of corporations, partnerships or entities having special status (such as S corporations). Although the underlying business operations generally are conducted for reasons having nothing to do with tax, the specifics of the capitalization and choice of entity may be designed largely to minimize federal, state, local or foreign tax liabilities.

4. Investment funds are often set up using structures that are intended to achieve a single level of tax for U.S. taxable investors while minimizing the tax burden on foreign and tax-exempt investors.[5]

5. Taxpayers sometimes engage in elaborate transactions that are carried out largely if not solely in order to obtain tax benefits. These types of transactions include many of the types of transactions identified by the Internal Revenue Service as "listed transactions" pursuant to Treasury Regulation § 1.6011-4(b)(2).

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[4] A patent has been approved for a strategy of this type involving the transfer of nonqualified stock options to a so-called grantor annuity trust ("GRAT"), U.S. Patent No. 6,567,790 (the "GRAT Patent").

[5] A patent application has been filed for a three-tier master-feeder structure for a regulated investment fund intended to avoid unrelated business taxable income for tax-exempt investors. Pub. No.: US 2006/0026085 A1, filed July 28, 2004 (published February 2, 2006).

Policy Issues Raised by Patents of Tax Strategies

Permitting patents for tax strategies potentially inhibits the ability of taxpayers to minimize their tax liabilities within the limits of the law. At the very least, a taxpayer would have to pay a royalty to the patent holder. Moreover, a patent holder could simply refuse to license her strategy, forcing the taxpayer to pay more in tax than is legally required. In theory, it is possible that allowing patent protection for tax strategies could result in net savings to taxpayers if such strategies would not have been developed or made available absent patent protection. Our experience suggests, however, that tax advisors do not need the protection of the patent laws to develop tax strategies or to comply with their obligations to represent the interests of their (usually paying) clients. Our experience also suggests that creative, sound tax planning ideas are generally available and widely discussed among practitioners and in the tax literature. [6]

The patenting of ideas or strategies relating to areas involving legal issues raises difficult issues not limited to the tax area. The tax laws, however, are perhaps unique in that they impose universal affirmative obligations of compliance on U.S. citizens and residents. The entrepreneur that wishes to set up a new business requiring some patented technology to operate always has the choice to pay the royalty or not to engage in the business in question, and will weigh the costs against the expected profits. But when the same entrepreneur enters into even the simplest transaction – for example, incorporating his sole proprietorship – he has no choice but to seek tax advice, if for no other reason than to report the transaction correctly on his tax return. The patenting of tax strategies would invariably increase the cost to taxpayers of complying with their tax obligations, a result we think is indefensible as a policy matter. For this reason, we believe that tax strategies and tax ideas should be generally available to all taxpayers. The tax law should be an open road, not a toll road.

A distinction can perhaps be drawn between tax advice relating to transactions that would occur without regard to their tax consequences (such as a business combination), and tax advice relating to transactions that would not take place, or would take place in a different form, but for tax considerations (such as a transfer to a trust for estate tax planning reasons). We believe that it is clearly undesirable to permit patent protection for even the most novel and creative tax analysis of a transaction that would occur without regard to the tax consequences. Once a transaction has occurred, a taxpayer is legally required to report and pay the proper amount of tax due. For example, prior to the enactment of section 197 of the Code (providing generally for the amortization of certain business-related intangible assets), it was generally assumed that

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[6] Our own publicly-available reports necessarily address a wide variety of tax strategy and planning issues. Our reports are usually prepared at the request of, and directed to, government officials. They are intended to provide helpful commentary on the practical or legal aspects of tax proposals under study by various branches of the government. See "Tax Section Reports" under www.nysba.org (sections).

purchased FCC licenses were not amortizable on the ground that they were very likely to be renewed and thus did not have a reasonably ascertainable useful life.[7] However, taxpayers later prevailed on the argument that such licenses were amortizable as franchises under former section 1253 of the Code.[8] However novel this argument might have seemed at the time, the purchase of a television station certainly cannot be viewed as a subject for patent protection and, once the station has been purchased, claiming amortization deductions is simply a matter of compliance with the tax law.

A more plausible case could perhaps be made for permitting patent protection for structuring transactions that would take place in a different form or would not take place at all, but for tax considerations. (We note that many such transactions are not abusive and that many are clearly contemplated by law.) Nonetheless, we do not believe that it is appropriate to impose a toll charge in the form of a royalty on a taxpayer's exercise of her right to arrange her affairs so as to avoid paying more tax than legally required.[9] In the case of tax strategies that embody behavior that the tax law specifically intends to encourage, permitting patent protection could frustrate Congressional intent. In addition, patent protection for certain strategies, such as those involving transfers of assets to trusts which incorporate certain tax-motivated provisions, would unduly restrict taxpayers' right to dispose of their property as they see fit and could be viewed as a restraint on alienability.

Some of these tax-motivated transactions may be described as tax shelters. We do not believe that, on a policy level, the issue of patentability bears any significant relationship to problems associated with tax shelters. It is unclear to us whether granting patent protection for abusive tax strategies would result in an increase in tax shelter activity as a result of incentivizing the development of tax shelters or would result in a reduction in such activity by reason of increasing taxpayers' cost of using such strategies. On balance, we do not believe that tax advisors would not seek to patent aggressive tax strategies, given that the patent application is a public document. To the extent that the disclosure and reporting rules for reportable transactions under Treas. Reg. § 1.6011-4 and Sections 6111 and 6112 of the Internal Revenue Code of 1986, as amended (the "Code") work as intended, patentability should not have a material effect on disclosure. We also believe that any implication that receipt of a patent evidences a governmental imprimatur for an abusive strategy can be avoided by the Internal Revenue Service issuing rules requiring disclosure that patent approval does not evidence validity as a matter of tax law. [10]

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[7] See, e.g., Forward Communications Corp. v. United States, 608 F.2d 485 (Ct. Cl. 1979); KWTX Broadcasting Company v. Commissioner, 31 T.C. 952 (1959), aff'd per curiam, 272 F.2d 406 (5th Cir. 1959).

[8] See, e.g., Jefferson-Pilot Corp. v. Commissioner, 995 F.2d 530 (4th Cir. 1993).

[9] A similar point was made in testimony by Dennis L. Belcher at the July 13 hearing.

[10] For example, it may be possible to require the inclusion on published patent materials of precatory language similar to that used on offering statements filed with the SEC, which generally provide that the SEC has neither approved nor disapproved the securities to be issued under the subject prospectus, and has not made a determination whether the prospectus is

Difficulties in Establishing Obviousness (or Lack Thereof)

We understand that one requirement for patentability of an invention is that the invention not be "obvious." Many tax strategies that may not be obvious to others are in fact obvious to seasoned tax practitioners. It is difficult to determine in the case of a particular tax strategy -- and probably impossible to generalize -- whether a skilled practitioner would be able independently to come up with the strategy without having heard about it from another practitioner or in the course of doing transactions. Especially in the case of strategies developed in response to changes in the tax law, a practitioner may be the first to devise a strategy that may not be at all apparent to a layperson or even to an average practitioner, but that other skilled practitioners will come up with on their own -- or would do so if the first practitioner did not describe the strategy in an article or a patent application -- within a reasonably short period of time. As a general matter, however, our collective experience leads us to believe that, for the most part, strategies developed to assist clients with structuring non-tax motivated transactions in a tax-efficient manner are more likely to be discovered independently by multiple practitioners -- and are in that sense more obvious -- than are strategies designed by practitioners or promoters out of whole cloth to present to clients who have no particular problem other than a desire not to pay taxes.

Many tax strategies are widely discussed among practitioners, and even with government officials at Treasury and the IRS. These types of strategies would be obvious, but, unless they are widely publicized in writing, not easily discoverable in the patent application process. Similarly, as discussed below, many tax strategies are so widely employed or generally known that they have never been reduced to writing, and appear only on taxpayer's tax returns in the form of numbers on a page. As tax returns are privileged, no patent examiner would ever be able to review them (and even if they could be reviewed, the exercise would be far more burdensome than finding a needle in a haystack). For these and other reasons, we believe that even highly skilled and trained patent examiners – and even very talented and knowledgeable IRS personnel – may in many cases be unable to determine whether a tax idea is obvious or not.[11] We believe that in the case of the GRAT patent, the idea was widely discussed in practitioner circles many years before the patent was applied for, but was not implemented due to non-tax law restrictions in effect at that time. When these restrictions were relaxed, the technique became practicable – but it was not new or non-obvious to gift tax practitioners.

Difficulties in Establishing or Challenging Originality of Tax Strategies

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accurate or complete. Under the securities laws, any representation to the contrary is a criminal offense.

[11] We understand that the Patent Office does have a policy of referring tax-related patent applications to the Internal Revenue Service for assistance in determining what is and is not obvious.

We believe that the practical difficulties of establishing or disputing the originality of tax strategies strongly militates against giving them patent protection. The circumstances in which tax strategies are developed in many cases make it difficult if not impossible to resolve issues as to whether such strategies are sufficiently original to merit patent protection. In many cases, strategies adopted by taxpayers are not publicly disclosed. A tax strategy may be embodied only on the taxpayer's return and/or advice provided by a practitioner. Tax returns are confidential, and tax advice is typically protected under the attorney-client privilege or the practitioner privilege provided by Section 7525 of the Code.[12] Although a tax strategy may be embodied in a document, such as a trust created for an individual taxpayer, that is not strictly speaking confidential or privileged, the document may not be readily discoverable by a third party.

Suppose, for example, that Practitioner X develops a tax strategy involving a trust, and uses that strategy on behalf of several of his clients. If Practitioner Y subsequently applies for patent protection of the strategy, Practitioner X's prior clients likely have no incentive to challenge the patent. In fact, the clients may have good reason not to publicly disclose that they employed the strategy, including concerns about possibly attracting an IRS audit as well as general concerns about the privacy of their financial affairs. Practitioner X may very well wish to challenge the patent in order to preserve the ability to employ the strategy on behalf of future clients without having to get permission from or pay royalties to Practitioner Y. However, it would be difficult if not impossible for Practitioner X to establish prior use of the strategy without violating his obligations of confidentiality owed to his former clients.

Issues as to What Constitutes Infringement

We also believe that granting patent protection for tax strategies poses substantial difficulties in determining what constitutes infringing conduct.[13]

Suppose, for example, that a taxpayer, based upon advice from a tax practitioner, employs a patented strategy without permission from the patent holder, and that the tax effect of the strategy is reflected on a return of the taxpayer prepared by a tax preparer.

In theory, some or all of the following actions could constitute infringement:

1. The tax practitioner's advice to the taxpayer to engage in the patented strategy (the "Practitioner's Advice");

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[12] We note that not all tax strategies are embodied only in confidential documents. For example, tax strategies relating to publicly offered securities are disclosed in documents filed with the Securities and Exchange Commission. In addition, tax strategies are often discussed in published articles and seminars.

[13] Many of the confidentiality-related considerations discussed above with respect to originality also make it difficult to discover whether infringement has occurred.

2. The taxpayer's engaging in the transaction that employs the strategy (the "Underlying Transaction");

3. The tax preparer's preparation of the return reflecting the effect of the strategy (the "Return Preparation"); or

4. The Taxpayer's filing of the return (the "Return Filing").

We do not see how treating the Return Preparation or the Return Filing as constituting infringement in and of itself can possibly be viewed as good policy. Once a taxpayer has engaged in a transaction, the preparer and taxpayer are legally obligated to properly reflect the impact of the transaction on the return. Compliance with legal obligations should not constitute patent infringement.

While a more plausible case might be made that the Practitioner's Advice and/or the Underlying Transaction could constitute infringement,[14] the argument that the Underlying Transaction constitutes infringement presumably would not be effective in the case of a strategy that consists of a novel analysis of the tax consequences of a transaction that would have been undertaken without regard to the tax consequences. Even where the specific form of the Underlying Transaction is influenced by tax considerations, we believe that it is often difficult to determine whether the particular form of a transaction constitutes infringement, given that the form of a particular transaction often will be driven as much by considerations peculiar to the specific business circumstances as by tax considerations.[15] Furthermore, common forms of transactions tend to evolve over time, thus making it difficult to determine whether a structure for which patent protection is sought is fundamentally different from an earlier structure or whether a new structure infringes upon a similar but distinguishable structure that was previously patented. This ambiguity poses a risk of inhibiting perfectly legitimate business transactions.

To the extent that the Underlying Transaction does not constitute an actionable infringement, we believe that the Practitioner's Advice likewise cannot be treated as infringement. Even if the Underlying Transaction does constitute an infringement, bringing an infringement action against the practitioner would be problematic.[16] Regardless of whether the taxpayer in the first instance asks the practitioner about the advisability of the Underlying Transaction or the practitioner

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[14] The only case of which we are aware that alleges infringement of a patented tax strategy is a currently pending case involving the GRAT Patent. *Wealth Transfer Group v. Rowe*, No. 06CV00024 (D. Conn. Filed January 6, 2006). Based upon the complaint, it appears that the alleged infringement is the defendant's transfer of an option to a GRAT (i.e., the Underlying Transaction).

[15] The lack of standardization of forms of transactions may be more frequently the case in certain types of transactions, such as joint ventures, than others, such as securities offerings.

[16] Of course, a practitioner would be responsible for advising a client about the possibility that a proposed transaction could result in patent infringement and presumably could be sued by the client if the practitioner does not provide proper advice on the patent issue.

suggests to the taxpayer that she undertake the Underlying Transaction, the Practitioner's Advice essentially constitutes an analysis of the legal consequences of a transaction. The ability to bring enforcement actions based upon the Practitioner's Advice would interfere with the practitioner-client relationship and raise serious issues with respect to the practitioner-client privilege.

Effects Upon Practitioners

In addition to the potential for throwing up roadblocks that taxpayers would have to navigate in organizing their own affairs, the patenting of tax strategies may interfere with the advisor's duties to his or her own client, and would impose burdens on the tax advisor that we feel are undesirable in the context of our complex and voluntary tax system. We as tax lawyers, like all lawyers, have ethical obligations to our clients to represent their interests zealously within the bounds of the law. If the advisor is aware of the existence of a patent that may cover advice she would otherwise give to her client, at a minimum the lawyer would be under a duty to inform her client of that fact. It also appears that the lawyer has an ethical obligation to research the patent law looking for patents covering any tax strategies that she might be recommending to her clients. The more obvious and well-known the strategy is, the less likely it will be that the lawyer would expect it to be patented. Unfortunately, as described above, it appears that some tax strategies that have been afforded patent protection cover techniques that are widely known, widely used and obvious. Requiring tax lawyers to research patent issues and to advise on the existence of and validity of patents covering proposed strategies could result in substantial additional costs to clients.

Moreover, if patents are permitted for tax strategies, tax practitioners may be discouraged from freely discussing tax issues with one another. Their interests may be better served by refraining from such discussions and instead keeping their ideas secret and seeking to patent them.

We believe that open discussions among tax practitioners are beneficial to practitioners, their clients, and the government. This exchange of ideas increases practitioners' understanding of the law and enables them to better serve their clients. We also believe that such discussions enable groups such as our own to provide recommendations to legislators and tax administrators that ultimately facilitate good tax policy.

Respectfully submitted,

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