

TESTIMONY  
OF  
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OF  
LOYOLA LAW SCHOOL (LOS ANGELES)  
BEFORE THE  
SUBCOMMITTEE ON SELECT REVENUE MEASURES  
OF THE  
COMMITTEE ON WAYS & MEANS

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Mr. Chairman and members of the Subcommittee, thank you for inviting me to speak here today. My name is Ellen Aprill. I am the John E. Anderson Professor of Tax Law and Associate Dean for Academic Programs at Loyola Law School in Los Angeles; I have had the privilege of serving in the Office of Tax Legislative Counsel in the Department of the Treasury in the late 1980's and as a law clerk to the Hon. Byron R. White, Associate Justice of the United States Supreme Court, in the early 1980's. I am currently a member of the Council of Directors of the American Bar Association Section of Taxation. While I first became aware of the issues related to the patenting of tax strategies through my involvement on the ABA Tax Section, I am speaking today in my individual capacity as a tax lawyer and tax professor. My comments represent my own personal views and are not necessarily those of Loyola Law School or any other organization with which I am affiliated.

Tax strategy patents are considered a subcategory of business method patents.<sup>1</sup> Representatives of the United States Patent and Trademark Office ("PTO"), who have been most generous, gracious, and helpful in discussing these matters, have explained that the PTO classifies tax strategy patents as subclass 36T in Class 705, "Data Processing: Financial, Business Practice, Management, or Cost/Price Determination."<sup>2</sup> The PTO website shows that 48 patents have been issued in that subclass and 81 such applications are pending.<sup>3</sup> These tax strategy patents have involved many aspects of the tax law, including financial products, charitable giving, estate planning, and tax-deferred exchanges.

The topic of patenting tax strategies raises a broad range of issues, from the most theoretical to the most practical. Questions of theory and policy include whether it is desirable for the patent law to authorize tax strategy patents and whether the government monopoly granted to a patent holder is fundamentally inconsistent with the policies underlying our tax system. Important practical issues include the impact on how tax practitioners advise their clients and their potential liability for inducing patent infringement. Issues in the middle of this spectrum include questions of institutional capacity, namely how best to ensure the quality of such patents.

Like other tax lawyers who have looked at this issue, I have concerns both about tax strategy patents that may not meet the patent criteria of novelty and non-obviousness and about others that may be novel and innovative, but are inconsistent with our tax laws. My testimony will address both categories, although I am, in fact, more concerned about the former – tax strategy patents that are not in fact novel – than the latter, tax strategy patents that are inconsistent with the tax law. I will begin with the practical issues raised by tax strategy patents, go on to the consideration of how we might improve the quality

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<sup>1</sup> After *State Street Bank & Trust v. Signature Financial Group, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998), held that business methods could be patentable subject matter, the number of business method patents exploded. Criticism of the concept of business method patents and the ability of the PTO to consider adequately prior art quickly followed. See Jay Dratler, Jr., *Does Lord Darcy Yet Live? The Case against Software and Business-Method Patents*, 43 SANTA CLARA L. REV. 823 (2003); cf. John R. Allison and Emerson H. Tiller, *The Business Method Patent Myth*, 18 Berkley Tech. L.J. 987 (2003).

<sup>2</sup> See <http://www.uspto.gov/go/classification/uspc705/sched705.htm>.

<sup>3</sup> See <http://www.uspto.gov/patft/index.html> (using search term ccl/705/36T in Advanced Search).

of tax strategy patents, and end by comparing the purposes of the tax law with the purposes of the patent law. In brief, I conclude that because a tax strategy patent constitutes a government-granted monopoly that turns on the interpretation of federal law, tax strategy patents differ from other business method patents in ways that require attention and action from the PTO, the IRS, associations of tax professionals, and this Subcommittee.

### **A. Tax Strategy Patents Could Change and Burden the Practice of Tax Law**

Compliance with the tax laws is enormously expensive and time consuming. However diligent and well-intentioned taxpayers and their advisers may be, compliance becomes more difficult every year. Proliferation of tax strategy patents will add to that difficulty. Tax practitioners and taxpayers will have to become more sensitive to the possibility that a tax strategy has been patented and adjust behavior accordingly.

The adverse consequences for violating or inducing the violation of patents can be substantial. Patent holders generally seek injunctions against alleged infringers as well as any inducers of infringement to bar them from acting without paying damages equal to lost profits or a reasonable royalty. A taxpayer can infringe a patent without intent or actual knowledge of the patent; ignorance of an applicable patent is not a defense to an infringement action. Moreover, patents have a presumption of validity; an alleged infringer defending use of a technique must show the invalidity of a patent by clear and convincing evidence. Patent infringement litigation is extraordinarily expensive.<sup>4</sup> Tax advisers whose clients face patent infringement suits may themselves face malpractice claims.

As a result, taxpayers, their advisers, and others may need to begin considering whether to conduct patent searches in connection with any tax planning activity, whether to seek expert advice, and depending on the results, what course of action to pursue in response to a possible patent claim. One prominent practitioner recently told me that a holder of a tax strategy patent obtained the list of all the attendees at a meeting held to consider the area of tax law involved in the patent. The patent holder sent all of the attendees a letter saying that their business activities might be infringing his patent. Some of those who received the letter in fact paid royalties, as the least costly course of action; others went through the burden and expense of asking their lawyers to review the patent to ensure that they were not guilty of any infringement.

Note that these burdens on the tax system are created without regard to whether the patent involves a tax strategy that the IRS would consider abusive. The mere possibility of a relevant tax strategy patent creates the compliance burden. Indeed, if the patenting of tax strategies were to flourish, I would expect that the additional burdens would be greater in connection with tax strategies that may not in fact be novel or non-

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<sup>4</sup> In 2005, the American Intellectual Property Law Association reported that the average patent infringement case as typically costing \$650,000 for each party when the amount at risk is less than \$1 million and \$2 million for each party when the amount at risk is between \$1 million and \$25 million. Am. Intellectual Prop. Law Ass'n, *Report of the Economic Survey* 22 (2005).

obvious than they will be for abusive tax strategies. Abusive planning techniques not only constitute a relatively small percentage of all tax planning, but also receive considerable attention from the IRS.

The proliferation of tax strategy patents would also affect professional culture. Historically, the dissemination of tax planning ideas has been open and widespread. Tax lawyers and accountants currently share information and ideas with each other freely. There is an astonishing array and number of meetings, conferences, conventions, and listservs where tax planning ideas are shared. Although the patent system is designed to encourage the dissemination and discussion of ideas and information, many tax lawyers are concerned that the spread of tax strategy patents will have the opposite effect, namely, that those with new ideas or the beginnings of ideas will hesitate to enter into discussion with others. If patents become an important part of the tax landscape, the atmosphere could become more secretive and less cooperative. The tax system as a whole will suffer if, in order to protect their patentable intellectual property, tax professionals are no longer willing to discuss, evaluate, and criticize each other's insights regarding how to comply with the tax system.

## **B. The Process of Examining Tax Strategy Patents Could be Improved**

### 1. Lessons from other kinds of business method patents.

In order to review the validity under the patent law of applications for tax strategy patents, patent examiners need expertise in software, finance, and tax. They need to understand the conceptual basis of a range of areas of tax -- financial products, estate and gift tax, pension and deferred compensation, to name a few where tax strategy patents already exist. Such expertise is difficult to obtain. Few tax lawyers have such broad knowledge in such varied aspects of the tax law. Most of us work very hard just to keep up in developments and changes in the law in our areas of specialization.

Tax strategy patents, like all other patents, must be both novel and non-obvious. For tax strategy patents, as with other patents, examiners look to prior art to determine novelty and non-obviousness. Identifying prior art in this area is particularly difficult. This is a new arena for patent law, and the traditional source for that determination, the body of pre-existing patents, is not helpful. In the case of tax strategy patents, to decide whether the idea for which the application is made is "new," examiners need to know how to go about doing specialized tax research in non-patent literature and must do such research as quickly and as efficiently as possible, particularly given the severe time constraints they face.<sup>5</sup>

To a large extent, these issues involving the learning curve of the PTO for reviewing tax strategy patents parallel the issues it faced with software, Internet and other business method patents after *State Street Bank*. Solutions found there will apply here as

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<sup>5</sup> I understand from the PTO that the average amount of time for examining a tax strategy patent is 32 hours.

well. In the years following the *State Street Bank* case, which established the validity of business method patents, many business method patents were subject to criticism as being invalid. Soon after *State Street Bank*, the PTO began partnerships and outreach efforts with business method customers, including requests for resources showing prior art and expanding non-patent literature information and data bases.<sup>6</sup> My understanding is that this collaboration has been successful and helped to improve the PTO review process.

The tax community, both public and private, has begun such a partnership with the PTO. I understand, for example, that the IRS recently provided several days of training on tax law to those in the PTO who examine tax strategy patents. Such training should be done regularly. Various associations of tax professionals have begun to study tax strategy patents and would be eager to help as well. For example, there was an overwhelmingly enthusiastic response when I asked tax law professors whether they would be interested in setting up a session to give PTO examiners training in how to do tax research thoroughly and quickly, and I am currently working with the PTO to try to arrange such a session. The PTO and the tax community need to continue to expand such efforts. In addition, the private tax bar needs to educate its members about the existence of tax strategy patents and their impact on tax practice. Such efforts are also underway.

Moreover, I urge various professional organizations to monitor individual applications for tax strategy patents and, as described below, to submit instances of prior art in connection with such applications. I also recommend that these organizations do regular reports on the nature of and issues involving tax strategy patents and patent applications. These reports could, for example, survey the number of such patents, their subject matter, issues involving prior art and non-obviousness as well as issues involving consistency with the tax laws. Such reports would enable the bar and policymakers to understand better the nature and dimension of this issue.

## 2. Special considerations applicable to tax strategy patents.

Two considerations seem to me to differentiate tax strategy patents from other business method patents. The first implicates the relationship between utility and public policy in the patent law. Under the patent law, a patent must be useful for some valid purpose. The usefulness of a tax strategy patent is likely to turn, at least in part, on interpretation of the tax law. That is, a tax strategy patent may achieve its intended purpose only if a particular interpretation of the tax law is correct or, at least, permissible. The issuance of the patent, however, does not decide the correctness of the legal interpretation. Patents are not a government seal of approval, although they are often seen – and marketed – as such.

Under the patent law, “[t]he threshold of utility is not high: An invention is ‘useful’ . . . if it is capable of providing some identifiable benefit.”<sup>7</sup> Although Justice Story wrote in the 19<sup>th</sup> century that inventions “injurious to the well-being, good policy,

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<sup>6</sup> See <http://www.uspto.gov/web/menu/busmethp/partner.htm>; Allison and Tiller, *supra* note 1, at 1024-25.

<sup>7</sup> *Juicy Whip, Inc. v. Orange Bang, Inc.*, 185 F.3d 1364, 1366 (Fed. Cir. 1999).

or sound morals of society” are unpatentable,<sup>8</sup> modern courts have avoided consideration of broad public policy in awarding patents and concluded that “[t]he requirement of ‘utility’ in patent law is not a directive to the Patent and Trademark Office or the courts to serve as arbiters of deceptive trade practices.”<sup>9</sup> Such policy decisions, the courts have declared, are the duty of other agencies or for Congress itself.<sup>10</sup>

Thus, the tax policy issues embedded in tax strategy patents are for the Treasury and the IRS, not the PTO, to consider. For many years, the Treasury and the IRS have been battling a constant flow of tax shelters and other questionable tax avoidance schemes. The IRS must be constantly vigilant in identifying new schemes and significant variations on old ones that require fresh IRS scrutiny to determine their validity under the tax laws. Tax patents, although they offer the IRS the advantage of public availability, are likely to make this task even more difficult. Patents carry with them the appearance of federal government approval and the legal presumption of validity. I am concerned that taxpayers and others who consider employing tax strategy patents will rely on the appearance of government approval and the presumption of validity a patent carries and, therefore, fail to evaluate carefully whether the underlying tax strategy actually works. If such is the case, the impact on federal tax revenue could be substantial.

To address such tax-specific concerns, I urge the Treasury and the IRS to consider establishing procedures by which every patent that involves tax strategies interpreting the Internal Revenue Code will be subject to IRS scrutiny as soon as possible, which currently would mean as soon as the patent application or the patent itself is made public on the PTO website. This IRS review would be followed, if needed, by a notice along the lines of notices now published in connection with potentially abusive tax shelter transactions alerting potential investors to possible liabilities if they participate in the transaction. The very existence of such a program by the IRS should discourage the filing of questionable patent applications. Its benefit would, I believe, outweigh the costs to the IRS of establishing such a review. Such a program is crucial to our learning the full scope and potential impact of the phenomenon of tax strategy patents, in particular the extent to which these tax strategy patents involve abusive tax shelters.

The other tax-specific issue relates to procedures for publication of patent applications. Under the patent regulations, a member of the public can submit publications relevant to a pending published patent application within two months of its publication date.<sup>11</sup> Since 2000, patent applications have generally been published within 18 months of their filing. However, a patent application can be kept confidential if the applicant certifies that the same idea will not be the subject of an application filed in another country requiring publication within 18 months after filing.<sup>12</sup> Since inventors generally desire protection of their ideas in other countries, most patent applications are

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<sup>8</sup> *Id.* (quoting *Lowell v. Lewis*, 15 F. Case. 1018, 1019 (C.C.D. Mass. 1817)).

<sup>9</sup> *Juicy Whip, Inc.*, 185 F.3d at 1368.

<sup>10</sup> *Id.*

<sup>11</sup> See 37 C.F.R. §1.99. Members of the public can also file protests based on prior art against pending applications, see 37 C.F.R. § 1.291, and cite prior art to the PTO during any period of enforcement, see 37 C.F.R. §1.502, as well as request reexamination, see 35 U.S.C. §302.

<sup>12</sup> 35 U.S.C. §122(b)(2)(B).

currently made public. I understand that the PTO estimates that approximately 10-15% of all patent applications and a slightly larger percentage of business method patents are kept confidential.<sup>13</sup>

For those tax strategy patents that are kept confidential, the public will be unable to submit to the PTO publications showing prior art, and the IRS will not be able to undertake early consideration of any policy issues implicated in a particular tax strategy patent. Because of the public policy issues involved in tax strategy patents, I urge that the PTO establish special publication rules to give the IRS access to all tax strategy patent applications.

The patent statute allows the Director of the PTO to determine “special circumstances” overriding confidentiality.<sup>14</sup> The patent regulations explain that the PTO, “either sua sponte or on petition, may also provide access or copies of all or part of an application if necessary to carry out an Act of Congress or if warranted by other special circumstances,”<sup>15</sup> and I would argue that such access is necessary to carry out the Internal Revenue Code. If the IRS had access to all applications for tax strategy patents early in the examination process, it could review the tax policy issues raised and prepare any necessary notices regarding the technique as a matter of tax law, as described above, before a tax strategy patent is issued and marketed. Meaningful and ongoing interagency cooperation in this regard is as essential as continuing education in tax developments for PTO examiners in order to monitor this emerging and potentially significant development. Efforts of this Subcommittee and its staff can help to ensure such cooperation.

If the PTO does not believe it has regulatory authority to permit the IRS with early access to tax strategy patent applications, legislation to authorize and direct the PTO to do so may be appropriate and desirable.<sup>16</sup> Other more general legislative changes to our patent law already under discussion, such as expanded post-grant opposition that would permit submission of “the common general knowledge of practitioners . . . not fully described in the published literature likely to be consulted by patent examiners,” could also be useful in ensuring the quality of tax strategy patents.<sup>17</sup> Proposed legislation

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<sup>13</sup> Allison and Tiller, *supra* note 1, at 1049 n. 192, observe that Europe does not recognize business method patents. Nonetheless, applicants may wish to permit the PTO to publish business method patent applications, including tax strategy patent applications, even if they will not seek foreign patent protection, since publishing a patent application offers the advantage of triggering liability for patent infringement as of the date of such application, rather than the date the patent issues. See 35 U.S.C. §154(d).

<sup>14</sup> 35 U.S.C. §122(a).

<sup>15</sup> 37 C.F.R. §1.14(h).

<sup>16</sup> Such legislation would help to guard against tax strategy patents that are novel in ways inconsistent with the tax laws, but would not guard against the grant of patents for which prior art in fact exists. The need for public input on prior art might argue for making all business method patent applications or at least all tax strategy patents public in order that members of the public could submit instances of prior art during the examination process, but such a change to the patent law would, I realize, alter substantially the current balance between public access and confidentiality struck by the statute.

<sup>17</sup> Bronwyn H. Half and Dietmar Harhoff, *Post-Grant Reviews in the U.S. Patent System – Design Choices and Expected Impact*, 19 BERKELEY TECH. L. J. 1, 13 (2004) (quoting NAT’L ACAD. OF SCI., *A PATENT SYSTEM FOR THE 21<sup>ST</sup> CENTURY* (Stephen A. Merrill et al. eds, 2004) at 5. See Hearing before the Subcommittee on Courts, the Internet, and Intellectual Property of the Committee of the Judiciary, House

applicable to all business method patents would be helpful for the issues raised by tax strategy patents as well.<sup>18</sup>

### **C. Patent Policy and Tax Policy Differ in Important Ways**

The fundamental purpose of providing patents, as I understand it, is to promote innovation. While no one can dispute this as a generally desirable goal, it would be hard to identify a subject less in need of further innovation than tax planning. Existing economic incentives already provide ample inducement for the development, promotion, and implementation of tax planning strategies.

The primary purpose of our tax laws is to raise money for the government and protect the public fisc. Many, perhaps most, tax strategy patents have as their fundamental objective the reduction of federal tax liabilities. While taxpayer efforts to reduce taxes are, of course, permitted and tax advisers spend many hours in such efforts, tax strategy patents seem to me different from such efforts because patents constitute a government-sanctioned monopoly. If tax strategy patents and their use proliferate, encouraged by the marketing advantages conferred by patents' government-granted monopoly and presumption of validity, many tax lawyers anticipate that there will be a corresponding reduction in federal tax revenues, generating revenue losses that would have to be made up from other sources. Granting a government monopoly in the form of a patent that undermines another key federal function -- the collection of revenue -- seems peculiar, if not contradictory, and raises fundamental questions about the appropriateness of such patents.

Of course, decisions to limit patent protection legislatively should be taken only after much deliberation and study.<sup>19</sup> Experience with the review programs by professional organizations and the IRS suggested above could be enormously helpful in evaluating whether legislation prohibiting tax strategy patents should be enacted. The need for careful deliberation, however, does not rule out the need to consider such an approach. My hope is that this hearing will be the first step in such consideration.

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of Representatives, on Patent Quality Improvement: Post-Grant Opposition, 108<sup>th</sup> Congress, 2<sup>nd</sup> Session, June 24, 2004, Serial No. 91.

<sup>18</sup> See Hearing before the Subcommittee on Courts, the Internet, and Intellectual Property of the Committee of the Judiciary, House of Representatives, on The Business Method Patent Improvement Act of 2001, H.R. 1332, 107<sup>th</sup> Congress, 1<sup>st</sup> Session, April 4, 2001, Serial No. 5.

<sup>19</sup> For Congressional limitations in connection with patents on particular technologies, such as the provision immunizing physicians, hospitals, and other health care providers for infringement liability for using patented medical procedures, see Allison and Tiller, *supra* note 1, at 994 n 19. Congress has enacted some special rules for business method patents. The First Inventor Defense Act of 1999, Pub. L. No. 106-113, 113 Stat. 1536 (codified as amended at 35 U.S.C. §273), creates a special patent-infringement defense if an inventor used a business method in secret and was later sued by a patent holder who had subsequently been granted a patent on the method.

#### **D. Summary and Conclusion**

Allow me to summarize the various concerns I have identified. The proliferation of tax strategy patents would change and burden tax practice. Given such an impact, it is important that we act to ensure that the examination process be as accurate as possible, particularly with respect to identifying prior art. The PTO should be provided the necessary resources and training. Professional organizations have a role to play, both in helping to train PTO personnel and in identifying prior art. Given the significance of such patents to the proper administration of the tax law, I have suggested removing any legal obstacles to sharing tax strategy patent applications with the IRS, so that the IRS can review all such patent applications and take appropriate and early remedial action where necessary. Cooperation between the IRS and the PTO is essential.

I ask that this Subcommittee continue to monitor tax strategy patents to determine whether they in fact undermine the efficacy of the tax laws and increase tax compliance burdens, as we tax lawyers fear, or, instead, provide additional incentives for innovation and increase openness regarding new ideas, as patent lawyers suggest. Such a determination will be vital to further, informed discussion of whether legislation should be enacted to prohibit or limit sharply tax strategy patents.

In closing, I suggest that this Subcommittee view tax strategy patents not as an instance of the now-established category of business method patents, but as an instance of a potential new category -- legal method patents. Tax strategy patents differ from other business method patents in that they depend on the validity of an interpretation of law. If patents are permitted for interpretation of the federal tax laws, creative minds coupled with economic incentive will seek -- and obtain -- valid patents relating to interpretations of other areas of law, including, for example, litigation strategies. I ask the Subcommittee whether this is a desirable goal for a country based on the rule of law.

Thank you very much. I would be pleased to answer any questions.