

NEWS ANALYSIS

Will Supreme Court *Bilski* Review Eliminate Tax Patents?

By Jeremiah Coder — jcoder@tax.org

The recent grant of certiorari by the Supreme Court to hear the appeal of a patent case has the tax bar hopeful that an eventual decision could limit the prospect of future tax strategy patents.

The Court's decision to review *Bilski v. Doll*, No. 08-964, comes after the U.S. Court of Appeals for the Federal Circuit held in a 9-3 majority opinion that the "machine or transformation" test is the relevant test in determining patent-eligible subject matter. In rejecting Bilski's patent claim, the *en banc* court reversed course in refusing to apply the "useful, concrete, and tangible result" test announced in *State Street Bank* a decade ago. (*State Street Bank and Trust Co. v. Signature Financial, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998).) (For prior coverage, see *Tax Notes*, Nov. 10, 2008, p. 655, *Doc 2008-23291*, or 2008 TNT 213-3. For the Federal Circuit's decision in *In re Bernard L. Bilski*, No. 2007-1130 (Fed. Cir. Oct. 30, 2008), see *Doc 2008-23178* or 2008 TNT 212-13.)

Ellen P. Aprill, associate dean and law professor at Loyola Law School, Los Angeles, said determining how the Supreme Court could handle the issue is difficult. The issue the Court will be addressing is the Federal Circuit's machine-or-transformation test for patentability established in the *en banc Bilski* decision in light of the First Inventors Defense Act, legislation that was enacted as a reaction to *State Street Bank* and that specifically recognizes business method patents, she said.

Dennis Drapkin of Jones Day, who along with Aprill is cochair of the American Bar Association Section of Taxation's Tax Strategy Patenting Task Force, said the section has been closely following case law developments as "interested bystanders" concerning tax strategy patents, but it has the principal mission of education rather than advocacy of any position. Until recently, there was a relative dearth of decisions on patent issues coming from the Supreme Court, but the Court seems to have taken greater interest in the area during the past few years. The granting of certiorari in *Bilski*, because it is a major business method patent case, could indicate a new direction in the patent area by the Court, he said.

At least one federal district court has used the opinion to hold that a tax patent claim was not patentable. In *Fort Properties, Inc. v. American Master Lease, LLC*, No. SACV07-365 AG, (C.D. Cal., Jan. 22, 2009), the district court held that a patent for a

section 1031 like-kind exchange investment strategy failed the machine-or-transformation test because the only transformation or manipulation was of legal obligations and thus was not eligible for patentability.

In a denial of certiorari in 2006, several justices on the Supreme Court took the unusual step of writing a dissent about the need to address important patent issues. (*Laboratory Corporation of America Holdings v. Metabolite Laboratories, Inc.*, No. 04-607, 126 S.Ct. 2921, Jun. 22, 2006.) Justice Stephen G. Breyer, joined by Justices John Paul Stevens and David H. Souter, wrote that the case, in which the majority dismissed the petition for certiorari as improvidently granted, presented pressing patent questions that should have been resolved by the Court.

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Justice Souter has announced his retirement, and it is unclear how his replacement on the Court might view patent law issues. Supreme Court nominee Second Circuit Judge Sonia Sotomayor, while in private practice, dealt with intellectual property issues and, if confirmed, may come to the Court with strong views on patents.

Prof. Michael Lang of Chapman University School of Law in Orange, Calif., said that tax strategy patents will continue to be an area of concern among tax practitioners. Congress may now be more reluctant to address the issue through legislation, choosing instead to wait until the Supreme Court has rendered a decision about the viability of business method patents. In the meantime, practitioners should continue to be concerned about whether a tax strategy they suggest to a client infringes on a current patent, he added. And many attendant ethical issues remain, a focus that Lang has been writing and speaking on.

"The bottom line is that the whole area is going to be uncertain for a while," Lang said. "The problem isn't going away."

The issue of tax strategy patents has received congressional interest. In the 111th Congress, several bills have been introduced to ban the granting of tax patents, including part of the Stop Tax Haven Abuse Act introduced in both chambers. (For the bill (S. 506) by Sen. Carl Levin, D-Mich., see *Doc 2009-4588* or 2009 TNT 39-28. For the bill (H.R. 1265) by House Ways and Means Committee member Lloyd Doggett, D-Texas, see *Doc 2009-4580* or 2009

TNT 39-29. For a bill (H.R. 2584) introduced May 21 by Rep. Rick Boucher, D-Va., see *Doc 2009-11698* or *2009 TNT 97-20*.)

Prof. Linda Beale of Wayne State University Law School said that the Supreme Court's granting of certiorari in *Bilski* is a significant development. "The fact that it granted cert suggests that the Court is ready to make a further definitive statement on patentable subject matter," she said. "It could go either way — either tightening availability of patents for nontechnological arts or undoing the narrower scope established in *Bilski*. It is a case worth watching."

In a posting to the Patent Docs blog, intellectual property lawyer Kevin Noonan (Judge Sotomayor's ex-husband) wrote that the *Bilski* certiorari grant was most likely indicative of interest in overruling the Federal Circuit. "Since it is rare for the Supreme Court to take a decision merely to affirm," he said, "it is likely that the Federal Circuit's 'machine or transformation' test will be modified if not completely abrogated." The Federal Circuit's decision in *Bilski*, which set out a bright-line test for method claim patentability, puts it squarely at odds with the Court's tendency to favor a more holistic approach toward patent law. "Almost the entire history of the Court's recent patent jurisprudence reversing the Federal Circuit has come in nullifying such bright line rules," Noonan noted.

'The fact that it granted cert suggests that the Court is ready to make a further definitive statement on patentable subject matter,' Beale said.

A white paper posted on CFO.com, written by Markets, Patents & Alliances LLC, however, argues that tax patents are valuable tools for the tax community. (For the paper, see <http://www.cfo.com/whitepapers/index.cfm/download/13603456>.) The article claims that the patenting of tax strategies will "encourage the full disclosure of advances in financial product design" and "encourage sustained high levels of investment." And contrary to a common misconception, tax patents would not allow the patenting of abstract strategies to achieve tax benefits, the paper stated.

A Quick Historical Rundown

Cause for concern over tax patents largely began after John Rowe, a former chair of insurance giant Aetna, was sued in federal district court for allegedly infringing on a company's SOGRAT patent (the strategy involves funding grantor retained annuity trusts with nonqualified stock options). (See *Wealth Transfer Group LLC v. Rowe*, D. Conn., No.

3:06cv00024 (AWT), filed January 6, 2006.) The infringement action was supposedly brought after Wealth Transfer Group's attorneys attended a tax conference and took down the names of participating lawyers who were at a panel discussion on estate planning techniques where the SOGRAT strategy was talked about. Although the suit eventually settled out of court, depriving the court of an opportunity to determine the validity of the patent, the case sent shockwaves through the tax community.

The ethical concern in the tax patent debate is over what tax practitioners must do to protect themselves from claims of malpractice. With notice that tax patent holders are out there looking to enforce their patent claims, tax lawyers must be wary that any tax planning they do for clients could run afoul of an existing patent. As such, some tax professionals have been advising practitioners to go through the additional efforts of searching for patent claims to ensure that a strategy they are recommending for a client will not lead to infringement suits.

There is a litany of arguments against allowing tax patents. Many tax lawyers would argue that strategies using the tax code should not qualify as patentable inventions. And the Congressional Research Service has noted that some experts believe tax patents are "inappropriate because they are said to inject private control over a system of public laws," preventing taxpayers from using commonly provided tax rules. (See CRS report, "Patents on Tax Strategies: Issues in Intellectual Property and Innovation," *Doc 2008-1956* or *2008 TNT 21-23*.) If nothing else, there is the possibility, some tax practitioners argue, that the granting of patents will mislead taxpayers into assuming that holding a patent ascribes government-approved legitimacy to the patent holder's tax strategy. At the very least, the Patent and Trademark Office (PTO) is faced with applying traditional patent application review in an area of law in which it lacks experience.

According to the PTO, as of January 2008, 60 tax patents have been issued. The IRS has responded with relative caution. It has assisted the PTO in providing training to patent examiners on determining prior art and novelty in the tax law area. The IRS also issued proposed regulations in 2007 that add the patented transactions category of reportable transactions to reg. section 1.6011-4. (For REG-129916-07, see *Doc 2007-21745* or *2007 TNT 187-10*.)

No court has yet directly dealt with the viability of a tax strategy patent. *In re Comiskey*, 499 F.3d 1365 (Fed. Cir. 2007), held that mental processes by themselves are not patentable, but could be if combined with a machine. That ruling, if adopted

and fleshed out by other courts down the road, could further legitimize tax patents to the extent such patent claims are tied to computerized processes in implementing the strategy.

The Supreme Court's ultimate decision whether the machine-or-transformation test is applicable in business method patents will likely determine the future of tax strategy patents. If the Court upholds the Federal Circuit's decision, in whole or in part, then tax patent applicants might have a more difficult time convincing the PTO to grant their patent requests, but it is still possible as long as the dictates of *State Street* permit all business method patents to go forward.

Because it is unlikely that a wholesale reversal on business method patents will occur, what will immediately please the tax bar is if the Supreme Court limits the application of *State Street*, such as by declaring tax strategy patents off-limits. But without the tax questions squarely in front of the justices, that result may be wishful thinking. If the Supreme Court fails to address the tax angle to the bar's satisfaction, a renewed push for legislation may develop. ■

Draft Healthcare Reform Bill Coming This Week, Baucus Says

By Meg Shreve — mshreve@tax.org

The Senate Finance Committee is moving closer to a markup of a potential healthcare reform bill, as committee Chair Max Baucus, D-Mont., told reporters last week that his committee could release a draft of the legislation on June 17.

Baucus, who met with Democratic and GOP taxwriters on the subject of healthcare last week, said he expected to receive more scores for potential pieces of a bill from the Congressional Budget Office early this week, while a Joint Committee on Taxation revenue estimate for capping the tax exclusion for employer-provided coverage is expected.

Baucus told reporters that a proposal potentially limiting the exclusion could have a "very generous grandfather provision" and would be at a "high enough level so it won't affect very many people." (For prior coverage, see *Tax Notes*, June 8, 2009, p. 1183.)

Baucus said that after he gathers those scores and gets reaction from committee members, a final bill could be ready June 19 with a markup starting June 23. That markup could last four days, he added.

Proposals potentially limiting the tax exclusion for employer-provided health coverage could have a 'very generous grandfather provision,' Baucus said.

A recent letter from the JCT to Baucus and Finance ranking minority member Chuck Grassley, R-Iowa, laid out several options for limiting the tax exclusion. Among them is capping the exclusion at the actuarial value of the Federal Employees Health Benefit Plan Blue Cross/Blue Shield 2010 option and indexing it to the per capita medical cost growth index, which would raise \$418.5 billion over 10 years. That cap could also be limited to filers making more than \$100,000 or joint filers making more than \$200,000 (\$161.9 billion over 10 years). A third option would raise \$1.7 trillion over 10 years by limiting the exclusion to half the premium. (For the JCT letter, see *Doc 2009-12993* or *2009 TNT 108-35*.)

Meanwhile, the Senate Health, Education, Labor, and Pensions (HELP) Committee held a roundtable discussion on its bill, the Affordable Health Choices

CORRECTION

Articles in the May 18 and June 1 editions of *Tax Notes* incorrectly attributed a comment concerning possible legislative action on carried interest and tax reform to a Treasury official. ["Officials Address Guidance on COD Income, Other Compensation," *Tax Notes*, May 18, 2009, p. 830; "Partnership Guidance on Hold Pending Legislative Action," *Tax Notes*, June 1, 2009, p. 1079, *Doc 2009-11973*, *2009 TNT 100-3*.]

Both stories incorrectly attributed a May 8 statement that carried interest legislation may be attached to tax reform to Steven Frost, senior counsel in Treasury's Office of Tax Legislative Counsel. That remark was actually made by David F. Pearce Jr. of the Real Estate Roundtable.

Tax Analysts regrets the errors. ■

