Estate & Succession Planning Corner

By Lawrence I. Richman

Tax Strategy Patents

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Article I, Section 8, Clause 8 of the Constitution provides that Congress shall have the power "To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." While Clause 8 does not use the word patent, it is the constitutional basis for our patent laws. These laws are not intended to bless monopolistic practices. Rather, the intent is to protect the discoveries of inventors and authors, but only so long as doing so promotes science and the useful arts.[1]

Historically, for an idea to be patentable it first must have taken physical form.[2] Concepts of novelty and utility also have been fundamental to patentable ideas.[3] In 1952, Congress required that for a patent to issue an innovation be "nonobvious" such that it not be an improvement that would be obvious to a person having ordinary skill in the pertinent art.[4]

The ability of the government to create a property right in business methods was established in 1998 in *State Street Bank and Trust Co. v. Signature Financial, Inc.*[5] In *State Street* the court held that a program that transferred data representing dollar amounts into final share prices by the use of mathematical calculations was patentable. By explicitly providing that a business method was eligible for patent protection the court gave the green light to the USPTO to allow patents for tax strategies. Recently the Patent Office established Subclass 36T in Class 705 expressly for tax strategies.

According to the General Counsel of the U.S. Patent and Trademark Office, "the examiner who is assigned a patent application involving a tax strategy

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examines that application using the same statutory requirements for patentability under 35 USC 101 (useful), 112 (disclosure requirements), 102 (novel), and 103 (non-obvious) as that examiner would use in examining any other technology."[6] The statement is illuminating, both in what it says and in what it does not. By equating tax strategies with "any other technology," the USPTO seems to operate in a sphere separate and apart. It ignores or minimizes the role of Congress in setting tax policy and the Treasury Department in interpreting the intent of Congress. It also seems to fail to recognize the fulsome role of the Bar and professional associations and publications in explaining the nuances of tax law and how tax code provisions and regulations may be applied. The failure to recognize the ways in which these official and nonofficial organs determine what is "useful," "required," "novel" and "nonobvious" in the development of tax strategies can lead to unintended consequences at best and at worst chill tax compliance and the understanding of tax law by discouraging the free flow of ideas, independent innovation and information. Instead of a tax system based on transparency and the lively exchange encouraged by the tax writing committees of Congress and the Treasury Department, the USPTO would seem to encourage practitioners to race to the patent office to secure private gain.

The tax strategy infringement case brought by Wealth Transfer Group, LLC for infringement of U.S. Patent 6,567,790[7] highlights the important policy and practical issues that arise when a patent is issued for a tax strategy. In reviewing the facts of the case and the actual patent itself, it is important to understand that the independent development of an identical tax strategy is not a defense to patent infringement. The law applicable to trade secrets and the law applicable to patents are materially different.

The complaint in *Wealth Transfer Group LLC* is simple and clear. Wealth Transfer asserts that the Defendant and one or more persons or entities along with Defendant infringed or have induced infringement of its patent 6,567,790. The relief sought is a permanent injunction and damages in an amount not less than a reasonable royalty. There is no allegation that the Defendant knew of the patent, that the Defendant acted intentionally or even that what was patented is in accord with the tax law.

The allegations are not there because they are not relevant and that highlights what in some ways may be most alarming: that in a new era in which tax strategy patents are issued, practitioners and clients (and it was the client who was sued in the instant situation) would be required to perform due diligence at the patent office on their tax planning to determine if they may proceed without infringing upon an existing patent. If there is a patent on the planning technique, the practitioner and the client have to hope that they can use it by being allowed to pay a royalty that is reasonable and affordable. This represents a huge change in the practice of tax law. On the one hand, it may increase the government's revenue by encouraging clients to avoid the potential patent morass by doing nothing and paying the additional tax freight; alternatively, it may encourage clients to believe that the best estate plan a client can buy is one that's patented.

> [P]ractitioners may wonder whether [tax strategy] patents … truly foster innovation or in words of the Constitution whether a tax strategy patent "promotes the … useful arts."

It is worthwhile to review the substance of the patent that is the subject of the litigation: patent 6,567,790. The text of the patent states that the object of the invention "is to provide a means by which a holder of nonqualified stock options may transfer the value of the options to family members with minimum transfer tax liability."[8] The Method by which the object of the invention is accomplished is described as follows:

> According to the present invention, the holder (grantor) establishes a Grantor Retained Annuity Trust (GRAT) and transfers stock options and possibly other assets to the GRAT. The grantor retains a right to receive an annuity amount stated as a percentage of the initial transfer. The annuity payment comprises cash, stock options, or other assets. At the end of the GRAT's term, the assets of the GRAT are distributed to one or more family member beneficiaries or a trust for the family member's benefit. The taxes on the transfer of assets are minimized by (1) calculating an optimum annuity percentage to reduce the value of the taxable gift, and (2) minimizing estate taxes through use of the GRAT. The present

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> invention also determines the length of the term of the GRAT, beginning and end of year asset value, and the form of payment of the annuity each year based on either estimated or actual input variables as selected by the user.[9]

It is probably a fair statement to say that many practitioners that have prepared GRATs for clients have had virtually the same object and method in securing the tax advantages of a GRAT for his or her client.

The patent calls its invention a SOGRAT (Stock Option Grantor Retained Annuity Trust) and explains that it is a method for transferring wealth through the funding of a GRAT with nonqualified stock options and possibly also with some cash. The patent illustrates the invention by way of example in which

> [T]he grantor… transfers $311,431 in cash and 100,000 nonqualified stock options… to a ten-year GRAT… The cash is included to be used to pay the annuity in case the value of the options decreases, in order to keep the options in the GRAT… for as long as possible. The annuity amount is fixed and will require more options to reach that fixed amount if the options have decreased in value. The optimum annuity… is that which results in the lowest possible gift, and is determined by calculating an annuity payment that will as closely as possible equal on a present value basis the principal contributed to the GRAT. The calculation complies with IRS Revenue Ruling 77-454 and various regulations, including Treasury Reg. sctn.25.7520-3(b)(2)(v) Example 5. Computer software applications are available that perform this calculation, such as NumberCruncher by Leimberg & LeClair, Inc., of Bryn Mawr, Pa. and zCalc by Lexcite Development, LLC of Arlington Heights, Ill. The optimum annuity percentage in the example… is 14.50221% of the assets transferred to the GRAT…, or $314,325. The cash will be paid out of the GRAT… first, allowing the options to have more time to appreciate, the goal being to maximize the number of options left in the GRAT at the end of the GRAT term. The gift is valued at $93,364 based on the value of the assets transferred to the GRAT less the present value of the annuity and a mortality component. The grantor… must pay at a rate of up to 60% of the gift value as the gift tax… to the IRS… in an amount as high as $56,018….
>
> In the basic embodiment of the present invention, the GRAT… will then distribute its remaining assets to the grantor's children. In the best mode, the GRAT… will instead distribute the assets to an Irrevocable Life Insurance Trust (ILIT)…. The ILIT… is ideally set up when the GRAT… is started, funded… with the gifts from the grantor... The purpose of the ILIT… is to provide a life insurance policy insuring… the grantor… that can cover the estate taxes if the grantor…dies before the natural expiration of the GRAT…, whereupon all the assets of the GRAT… go to the grantor's estate, depending on the terms of the GRAT. The policy has the ILIT… as its named beneficiary, and the children are the ultimate beneficiaries of the ILIT. In addition, if the grantor… lives to the end of the term of the GRAT…, the assets distributed to the ILIT… would be available to be used to purchase additional life insurance, for the split dollar rollout, or continued premium payment.[10]

As tax practitioners know, planning approaches invariably are modified to meet the specific circumstances and goals of individual clients. Patent 6,567,790 takes this into account and includes the following catch-all statement as its conclusion. "Although the invention has been shown and described with respect to a best mode embodiment thereof, it should be understood by those skilled in the art that various changes, omissions, and additions may be made to the form and detail of the disclosed embodiment without departing from the spirit and scope of the invention…"[11]

Practitioners may shake their heads and wonder if in the words of the immortal Yogi Berra the patent isn't "deja-vu all over again." In fact, practitioners may wonder whether patents in this area truly foster innovation or in words of the Constitution whether a tax strategy patent "promotes the … useful arts."[12]

In response, The House Committee on Ways and Means held a hearing on the subject on July 13, 2006. As one might expect, not all the testimony expressed concern about this development in the law. In fact, among the claimed benefits of tax strategy patents are that they (1) validate the expertise of the developers of the patent, (2) provide a way for patent holders to differentiate their products from those of their competitors, (3) channel competitor's actions away from the domain of product development or compel them to pay royalties for access to products, (4) provide

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business intelligence information which can drive innovation efforts of competitors by forcing them to design around the patent, (5) increase the development of specialized expertise which will strengthen specialization and firm differentiation and (6) filter out less innovative firms.[13] These sentiments endorse the forces that seek to transform the practice of tax law from a profession into a business. The competitive economic forces that led to the recent spate of risky tax shelters for profit may be enhanced by the receptivity of the Patent Office to tax strategy patents.

According to the General Counsel of the U.S. Patent and Trademark Office as of July, 2006, 41 patents had been issued related to tax strategy, with a further 61 tax strategy patent applications pending.[14] This would indicate that while the gates are open, the flood has yet to begin. To its credit, the American Bar Association Section of Taxation announced on October 5, 2006 that it would form a task force to explore the issue of patenting tax advice. One sign that the gates may be closing is the introduction by Senators Levin, Coleman and Obama on February 17, 2007, of the Stop Tax Haven Abuse Act, which in Section 303, intends to prohibit patents "designed to minimize, avoid, defer, or otherwise affect the liability for Federal, State, local or foreign tax…." Pending further guidance or the enactment of such legislation, Caveat practitioner!

Endnotes

1 *A&P Co. v. Supermarket Equipment Corp.*, SCt, 340 US 147, 71 SCt 127 (1950).

2 *Clark Thread Co. v. Williamantic Linen Co.*, SCt, 140 US 481, 11 SCt 846 (1891).

3 *Graham v. John Deere Co.*, SCt, 383 US 1, 86 SCt 684 (1966).

4 Patent Act of 1952, 35 U.S.C. §103.

5 *State Street Bank and Trust Co. v. Signature Financial, Inc.*, CA-FC, 149 F.3d 1368 (1998).

6 Statement of James Toupin, General Counsel, U.S. Patent and Trademark Office, Testimony before the Subcommittee on Selected Revenue Measures of the House Committee on Ways and Means July 13, 2006.

7 *Wealth Transfer Group, LLC v. John W. Rowe,* DC Conn., No. 3:06-CV-00024-AWT filed Jan. 6, 2006.

8 United States Patent 6,567,790, USPTO Patent Full-Text and Image Database at page 6.

9 *Id.,* at page 6.

10 *Id.,* at pages 8-9.

11 *Id.,* at page 11.

12 U.S. Constitution Article I, Section 8, Clause 8.

13 Testimony of Richard S. Gruner, Professor of Law, Whittier Law School, before the Subcommittee on Select Revenue Measures of The House Committee of Ways and Means, July 13, 2006.

14 Statement of James Toupin, General Counsel, U.S. Patent and Trademark Office, Testimony before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means July 13, 2006.

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