

**When Worlds Collide: Applying the Nonobviousness and Novelty Requirements of Patent
Law to Tax Strategy Patents**

Roby Sawyers, Ph.D.*
Professor of Accounting
North Carolina State University
3106 Nelson Hall
Campus Box 8113
Raleigh NC 27695-8113
roby_sawyers@ncsu.edu
(919) 515-4443

Wade Chumney, JD, MSIS
Assistant Professor of Business Law
Belmont University
College of Business Administration
1900 Belmont Blvd.
Nashville, TN 37212
(615) 460-6810

David L. Baumer, Ph.D., JD
Professor of Law and Technology
Head, Department of Business Management
North Carolina State University
2344 Nelson Hall
2801 Founders Drive
Raleigh NC 27695
(919) 515-6950

January 24, 2008

* Corresponding author

When Worlds Collide: Applying The Nonobviousness and Novelty Requirements of Patent Law to Tax Strategy Patents

ABSTRACT: A proliferation of newly issued tax-related patents has resulted in concern and confusion among tax practitioners. Tax practitioners claim that some of the tax strategies claimed in the patents have been used for many years and don't meet the novel and nonobvious requirements of the patent law and that others simply don't work. Nevertheless, tax advisors and their clients worry that they may be in jeopardy of being sued as defendants in tax related patent infringement cases. Tax advisors are also concerned that enforcement of these patents will limit their ability to serve as advocates for their clients and recommend tax strategies that legally minimize their clients' taxes.

In this paper, the authors examine five tax strategy patents in detail and examine published articles, IRS Revenue Rulings, Private Letter Rulings, continuing education materials and other evidence in publicly available printed publications in order to determine whether the "prior art" in the field was sufficient at the time of a patent application in order to potentially negate the novelty and nonobviousness requirements of patent law.

Keywords: Tax Strategy, Patents, Novelty, Nonobviousness

INTRODUCTION

Over the last year or so, tax professionals have become increasingly concerned over the patenting of tax strategies. Much of the concern is a direct result of a suit filed in January 2006 alleging the infringement of a patented estate planning technique in which non-qualified stock options were used to fund a grantor retained annuity trust (GRAT).¹ U.S. Patent No. 6,567,790 (commonly referred to as the “SOGRAT” patent) issued on May 20, 2003 describes an estate planning method for minimizing transfer tax liability in connection with the transfer of nonqualified stock options to a family member utilizing a GRAT. In a typical GRAT, the grantor established an irrevocable trust and receives a payment of a fixed annuity amount for a specified number of years (which the grantor is expected to outlive). At the end of the term of years, the remaining trust assets pass to the named beneficiaries (typically family members). The key is that the grantor’s transfer of property to the GRAT is treated as a gift to the remainder beneficiaries and the value of the gift is discounted equal to the present value of the remainder interest as determined using IRS valuation tables.

For example, assume a taxpayer creates a GRAT for a term of ten years and funds the trust with \$1 million. The grantor retains the right to receive a 10 percent annuity for the term of the trust. Accordingly, the grantor will receive \$100,000 from the trust each year. If the applicable interest rate at the time of the transfer is 8.6 percent, the present value of the remainder interest (and the taxable gift) would be \$395,600.² GRATs have been used by tax practitioners for many years.

¹ *Wealth Transfer Group L.L.C. v. John W. Rowe*, Docket No. 3:06-cv-00024-AWT (D-Conn). On March 9, 2007, the District Court approved a confidential settlement between the parties.

² The above example was published in the American Institute of Certified Public “Sophisticated Estate Planning Techniques- How and When to Use Them Videocourse” in 1999.

Since January of this year, the Tax Sections of the Texas, Florida and California Bar Associations, the Colorado Bar Association, the California Society of Certified Public Accountants and the American Institute of Certified Public Accountants have all publicly opposed the patenting of tax strategies providing a litany of arguments, including that tax patents preempt Congress's legislative control over tax policy, deny taxpayers equal and unfettered access to the provisions of the Internal Revenue Code and its interpretations, make it difficult for tax advisors to render advice to clients; might increase the costs of tax advice to clients, and may mislead taxpayers into thinking that a patented tax strategy is valid in the eyes of the IRS.

THE BASICS OF PATENT LAW

Although patent law rivals tax law in its complexity, there exist basic principles that are instructive. Ignoring caveats, “Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter...” is entitled to a patent.³ A patent is a right granted by the federal government to an inventor enabling him to exclude others from making, using, selling, or importing the invention within the United States without the inventor's consent.⁴ Patents are filed with the United States Patent and Trademark Office (USPTO) and generally last for a term of 20 years from the date of filing.⁵ For an invention to receive patent protection it must be: 1) new, 2) useful, and 3) non-obvious.⁶

The seminal case of *State Street Bank*⁷ created a new category of patents, business method patents.⁸ *State Street* has been interpreted to define business methods patents as patents for those methods of processing data and uniquely designed for or used in practicing,

³ 35 U.S.C. § 101 (2007).

⁴ 35 U.S.C. § 271.

⁵ 35 U.S.C. § 154(a) 2.

⁶ 35 U.S.C. § 101.

⁷ *State Street Bank & Trust Co. v. Signature Financial Group, Inc.*, 149 F. 3d 1368 (Fed. Cir. 1998).

⁸ Seema A. Khan, *Emerging Technologies: A Legal Tool Kit for Responding to Resulting Intellectual Property Issues* (2002).

administering, or managing an enterprise; techniques used in athletics, instruction, or personal skill; and any computer-assisted implementations of such methods and techniques.⁹ Court acceptance of business method patents has recently resulted in the application for and issuance of patents involving tax strategies.

In 2006, over 10,000 applications were filed for business method patents (categorized as Class 705) by the USPTO.¹⁰ Presently, tax strategy patents compose only a small fraction of business method patents and are published in subclass 36T of Class 705 which the USPTO created and dedicated solely to tax strategy patents. As of October 18, 2007 the USPTO has issued 60 patents in this subclass, with 101 applications pending. Other tax-related patents are found in subclass 31 dealing with “computerized arrangement(s) for determining or submitting a tax or tax form to a governmental entity,” subclass 35 dealing with “computerized arrangement(s) for planning the disposition or use of funds or securities, or extension of credit,” and subclass 36R, dealing with “computerized arrangement(s) for planning the selection or evaluation of securities or other investments for a single entity.”¹¹

In a July 2006 analysis of issues relating to the patenting of tax advice, the Joint Committee on Taxation noted that there were two general categories of tax related patents found in subclass 36T. The first are computer based in that they focus on the use of a computer as an integral part of the business method, while the second grouping relies on the tax strategy itself.

⁹ Joel M. Freed and Thomas C. Reynolds, *The New Patent Landscape*, Computer & Internet Lawyer, 1 at 2 (December 1, 2001).

¹⁰ U.S.P.T.O. at: <http://www.uspto.gov/web/menu/pbmethod/>.

¹¹ Two patents in these other subclasses have been alluded to in previous articles as “tax strategy” patents. We include these two in our analysis for a total of 62 patents.

The Joint Committee also noted that a few of the patents classified in subclass 36T by the USPTO appeared to not deal with taxes at all.¹²

Chumney et al. examined all of the “tax-related” patents found in subclass 36T, 35 and 36R in order to identify true tax strategy patents defined as patents in which the creator claims to invent a financial structure or product that is used in a strategy or process to reduce taxes.¹³ Consistent with the Joint Committee’s findings, the authors find seven patents in which taxes are not mentioned in the claims, background or embodiment or in which taxes do not appear fundamentally related to the patent. For example, Patent No. 6,342,272 deals with multi-layer corrosion resistant coatings and Patent No. 6,772,128 deals with a nuclear decommissioning insurance financial product and method.

In another 16 of the patents, taxes do not appear integral to the patent or are of secondary importance. For example, Patent Number 6,470,321 is a “system for providing an investor with financial protection against a loss in value in an investment in a limited liability entity arising from an event against which the entity is inadequately insured or has no insurance.”

Three of the patents are classified by Chumney et al. as basic tax computational software. This category includes Patent No. 6,058,376 which provides a computer implemented process for determining the tax and other financial implications of converting a traditional IRA to a ROTH IRA.

Fifteen patents deal with computer implemented systems and software for tax efficient investment portfolio management. The patents in this category generally provide software that helps clients and their advisors manage investment portfolios in order to appropriately harvest

¹² JCX-31-06, Background and Issues Relating to the Patenting of Tax Advice, Joint Committee on Taxation, July 12, 2006. It should be noted that while providing representative examples, the Joint Committee did not categorize all patents into these broad categories.

¹³ Wade M. Chumney, David L. Baumer and Roby B. Sawyers, *The Sky is Not Falling: An Empirical Analysis and Categorization of Issued Tax Strategy Patents*, working paper (2007).

tax losses, avoid running afoul of wash sale rules, keep track of tax lots to minimize tax implications of sales, and so forth. As an example, Patent No. 6,161,098 provides a “method an apparatus for enabling small investors to manage taxable events within a portfolio.”

In four patents, the tax implications are critical to the invention but nevertheless do not rise to the level of a tax strategy patent. These patents are explicitly designed to take advantage of favorable tax treatment or to avoid some unfavorable tax result. For example, Patent No. 6,611,808 claims a “method for determining additional death benefits and costs related to tax payments with respect to the death benefit of an annuity contract.”

Twelve of the patents use life insurance products in what the inventors claim to be novel ways of investing to avoid or save taxes associated with funding future health care costs of retirees, executive compensation plans, deferred compensation plans, wealth accumulation plans, exercising stock options, etc. In these patents, the creators often give their inventions names. For example, in Patent No. 5,991,744, the creator calls his plan a managed equity secured opportunity plan or MESOP. The invention focused on contributions to an account being used to invest in a life insurance policy which will ultimately provide tax-free growth of assets.

The remaining five patents are classified by Chumney et al. (2007) as tax strategy patents in which the creator claims to invent a financial structure or product that is used in a strategy or process to reduce taxes. For example, in Patent No. 6,292,788, the inventor claims to create a new financial instrument called a deedshare for performing tax-deferred real estate exchanges qualifying under IRC Section 1031. According to its inventors, the patent is superior to Real Estate Investment Trusts (REITs) in terms of control, risk, and qualifying for favorable tax treatment through Section 1031 of the IRC. In another example already mentioned, the creator of Patent No. 6,567,790 claims an invention (called a SOGRAT) that funds a grantor retained

annuity trust (GRAT) with stock options. According to its inventors, the method maximizes the transfer of wealth from the grantor of the GRAT to a family member by minimizing the amount of estate and gift tax paid. Other patents identified as tax strategy patents include Patent No. 7,149,712 dealing with the use of tax deferred annuities by charitable remainder trusts and other entities, Patent No. 7,096,195 described as a method for enhancing the equity of a business entity using share bonds and Patent No. 7,219,079 dealing with the creation of a convertible debt instrument that “through their provisions ... brings about successful market transactions that would otherwise not be possible.”

In the next two sections, we discuss the novelty and nonobviousness requirements of the patent law. We then examine the five identified tax strategy patents according to these guidelines.

The Novelty Argument

In order to determine whether a patent application filed for a tax strategy patent fails the novelty test, one must look to 35 U.S.C. § 102. Pursuant to this code section,

a person shall be entitled to a patent unless –(a) the invention was known or used by others in this country, or patented or described in a printed publication in this or a foreign country, before the invention thereof by the applicant for patent, or (b) the invention was patented or described in a printed publication in this or a foreign country or in public use or on sale in this country, more than one year prior to the date of the application for patent in the United States...¹⁴

Disclosures that are in existence prior to a patent application and related to the contents of a patent claim are termed prior art.¹⁵

To understand 35 U.S.C. § 102 (a) and (b), several phrases require further illumination. “The statutory language 'known or used by others in this country' means knowledge or use which

¹⁴ 35 U.S.C. § 102.

¹⁵ Donald S. Chisum et al., *Principles of Patent Law* at 80 (3d ed. 2004).

is accessible to the public.”¹⁶ Furthermore, the knowledge or use is considered to be accessible to the public if there has been no deliberate attempt to keep it secret.¹⁷ This portion of 35 U.S.C. § 102 (a) may be problematic in that tax practitioners often employ tax strategies with their clients in a proprietary manner without disseminating the tax strategy to the public.

Turning to § 102 (b), one must make note of the one-year prior to the date of application language. The next phrase to examine is “described in a printed publication”. A document may be considered a printed publication, “upon a satisfactory showing that such document has been disseminated or otherwise made available to the extent that persons interested and ordinarily skilled in the subject matter or art, exercising reasonable diligence, can locate it.”¹⁸

Furthermore, an electronic publication, including an on-line database or Internet publication, are considered by courts to be a printed publication so long as the publication was accessible to individuals concerned with the art to which the document relates.¹⁹ Disclosures on the Internet or on-line databases are determined to be publicly available as of the date the item was posted publicly.

When making the determination as to whether an invention is novel, one looks to the prior art. Doing so is known as determining whether the prior art *anticipates* the claims of a patent application. Of critical importance is the fact that generally, “a claim is anticipated only if each and every element as set forth in the claim is found, either expressly or inherently described, in a single prior art reference.”²⁰ Additionally, “the identical invention must be shown

¹⁶ *Carella v. Starlight Archery*, 804 F.2d 135 (Fed. Cir. 1986).

¹⁷ *W. L. Gore & Assoc. v. Garlock, Inc.*, 721 F.2d 1540 (Fed. Cir. 1983).

¹⁸ *In re Wyer*, 655 F.2d 221 (CCPA 1981) (quoting *I.C.E. Corp. v. Armco Steel Corp.*, 250 F. Supp. 738, 743 (SDNY 1966)).

¹⁹ See *Id.*, at 227.

²⁰ *Verdegaal Bros. v. Union Oil Co. of California*, 814 F.2d 628, at 631 (Fed. Cir. 1987).

in as complete detail as is contained in the ... claim.”²¹ The elements must be arranged exactly as required by the claim, though identity of terminology is not required.²²

Furthermore, pursuant to 35 U.S.C. § 102 (b), “any invention described in a printed publication more than one year prior to the date of a patent application is prior art under Section 102(b), even if the printed publication was authored by the patent applicant.”²³ Policy considerations for patents dictate that “once an inventor has decided to lift the veil of secrecy from his [or her] work, he [or she] must choose between the protection of a federal patent, or the dedication of his [or her] idea to the public at large.”²⁴ It should also be noted that merely possessing knowledge of the invention by the public does not warrant rejection under 35 U.S.C. 102(b), as this code section bars public use or sale, not public knowledge.²⁵ However, public knowledge may provide grounds for rejection under 35 U.S.C. 102(a).

One argument that has been posited by tax professionals and others is that some of the patents issued for tax strategies should not have been granted because the underlying process fails the novelty requirement of patent law. A fundamental problem faced by USPTO patent examiners in applying the novelty argument is “that substantial amounts of prior art might be found only by an expert in the field.”²⁶ While IRS Revenue Rulings, Private Letter Rulings and Technical Advice Memoranda as well as publicly available continuing education materials and articles appearing in tax publications meet the requirements of publicly available printed materials, using these materials to support an attack upon the novelty of an existing tax strategy patent would appear to be a very difficult task. The major impediment would be the requirement

²¹ *Richardson v. Suzuki Motor Co.*, 868 F.2d 122 at 1236 (Fed. Cir. 1989).

²² *In re Bond*, 910 F.2d 831 (Fed. Cir. 1990).

²³ *De Graffenried v. United States*, 16 USPQ2d 1321, 1330 n.7 (Cl. Ct. 1990).

²⁴ *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141 at 148 (1989).

²⁵ *TP Labs., Inc., v. Professional Positioners, Inc.*, 724 F.2d 965 at 970 (Fed. Cir. 1984).

²⁶ William A. Drennan, *The Patented Loophole: How Should Congress Respond to this Judicial Invention?*, 59 Florida Law Review, 229-331 (2007).

that each and every element of the claim would have to appear in a single prior art reference. In addition since tax advice is often not public and tax returns are typically confidential, the mere fact that a strategy was known and used before the patent application date does not make it public.

The Nonobviousness Argument

While many tax practitioners have argued against the novelty of various tax strategy patents, “the nonobvious requirement...is the most significant obstacle that a patent applicant faces.”²⁷ Additionally, it is a determination that involves a high level of ambiguity as compared to the novelty decision. As the Supreme Court has noted, “What is obvious is not a question upon which there is likely to be uniformity of thought in every given factual context.”²⁸ To analyze the amorphous animal that is nonobviousness, one must first turn to 35 U.S.C. § 103, which notes in pertinent part:

(a) A patent may not be obtained though the invention is not identically disclosed or described as set forth in section 102 of this title, if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains...²⁹

Pursuant to this determination of obviousness, the Supreme Court has enunciated four factual inquiries that must be addressed: (1) determining the scope and content of the prior art; (2) ascertaining the differences between the prior art and the claims in issue; (3) resolving the level of ordinary skill in the pertinent art; and (4) evaluating evidence of secondary considerations.³⁰ As the name implies, the secondary considerations are taken into account only

²⁷ Donald S. Chisum et al., *Principles of Patent Law* at 532 (3d ed. 2004).

²⁸ *Graham v. John Deere*, 383 U.S. 1 at 18 (1966).

²⁹ 35 U.S.C § 103.

³⁰ *Graham v. John Deere*, 383 U.S. 1 at 17 (1966).

after the first three are fully examined and include factors such as commercial success, long felt but unsolved needs, and failure of others.³¹

Later cases illustrate the application of these inquiries. In *United States v. Adams*³², the Supreme Court recognized that when a patent claims a structure already known in the prior art that is altered by the mere substitution of one element for another known in the field, the combination must do more than yield a predictable result. If a person of ordinary skill in the art can implement a predictable variation and would see the benefit of doing so, Section 103 likely bars its patentability. In *Sakraida v. AG Pro, Inc.*³³ the Supreme Court concluded that when a patent simply arranges old elements with each performing the same function it had been known to perform and yields no more than one would expect from such an arrangement, the combination is obvious. In *Ashland Oil v. Delta Resins and Refractories*³⁴, the Federal Circuit Court of Appeals employed a “teaching, suggestion or motivation” (TSM) test under which a patent claim is only proved obvious if the prior art, the problem’s nature, or the knowledge of a person having ordinary skill in the art reveals some motivation or suggestion to combine the prior art teachings. In *KSR International Co. v. Teleflex Inc.*³⁵ the Supreme Court reaffirmed the obviousness inquiries in *Graham* while noting that the Federal Circuit addressed the obviousness question in a narrow, rigid manner. While the TSM test provided helpful insights (that a patent composed of several elements is not proved obvious merely by demonstrating that each element was, independently known in the prior art), the Supreme Court also noted that:

³¹ *Id.* at 17-18.

³² *United States v. Adams*, 383 U.S. 39 at 50-52 (1966).

³³ *Sakraida v. AG Pro, Inc.*, 425 U.S. 273 at 282 (1976).

³⁴ *Ashland Oil v. Delta Resins and Refractories*, 776 F.2d 281 at 297 (Fed Cir. 1985).

³⁵ *KSR International Co. v. Teleflex Inc.*, 127 S. Ct. 1727 (2007).

The obviousness analysis cannot be confined by a formalistic conception of the words teaching, suggestion, and motivation, or by overemphasis on the importance of published articles and the explicit content of issued patents. The diversity of inventive pursuits and of modern technology counsels against limiting the analysis in this way. In many fields it may be that there is little discussion of obvious techniques or combinations, and it often may be the case that market demand, rather than scientific literature, will drive design trends.³⁶

Further noting that:

“When there is a design need or market pressure to solve a problem and there are a finite number of identified, predictable solutions, a person of ordinary skill has good reason to pursue the known options within his or her technical grasp. If this leads to the anticipated success, it is likely the product not of innovation but of ordinary skill and common sense. In that instance, the fact that a combination was obvious to try might show that it was obvious under section 103.³⁷

Scope and Content of the Prior Art

When analyzing the scope and content of the prior art, the following tenets of patent law must be adhered to: (1) the claimed invention must be considered as a whole; (2) the references must be considered as a whole and must suggest the desirability and thus the obviousness of making the combination; (3) the references must be viewed without the benefit of impermissible hindsight vision afforded by the claimed invention; and (4) reasonable expectation of success is the standard with which obviousness is determined.³⁸

Additionally, “it must be known whether a patent or publication is in the prior art under 35 U.S.C. § 102.”³⁹ This is due to the fact that subject matter that is prior art under the aforementioned code section can be used to support a rejection under section 103.⁴⁰ However, unlike the analysis under novelty in which one item of prior art includes all elements of the

³⁶ *Id.* at 1741.

³⁷ *Id.* at 1742.

³⁸ *Hodosh v. Block Drug Co., Inc.*, 786 F.2d 1136, note 5 at 1143 (Fed. Cir. 1986).

³⁹ *Panduit Corp. v. Dennison Mfg. Co.*, 810 F.2d 1561 at 1568 (Fed. Cir. 1987), *cert. denied*, 481 U.S. 1052 (1987).

⁴⁰ *Ex parte Andresen*, 212 USPQ 100 at 102 (Bd. Pat. App. & Inter. 1981).

claimed invention, multiple copies of prior art can be utilized in the obviousness analysis to find all elements of the claimed invention.⁴¹ Regarding the impetus for combining references, “There are three possible sources for a motivation to combine references: the nature of the problem to be solved, the teachings of the prior art, and the knowledge of persons of ordinary skill in the art.”⁴² The actual combination of references should only occur if, “the prior art would have suggested to those of ordinary skill in the art that they should make the claimed composition or device,” and the prior art also reveals that, “those of ordinary skill would have a reasonable expectation of success.”⁴³

Differences Between the Prior Art and the Claims in Issue

The second factual inquiry concerns a determination of the differences between the prior art and the claims in issue. The basis of this examination is, “whether the subject matter sought to be patented, as a whole, would have been obvious at the time the invention was made to a person having ordinary skill in the art.”⁴⁴ “It is difficult but necessary that the decisionmaker forget what he or she has been taught . . . about the claimed invention and cast the mind back to the time the invention was made (often as here many years), to occupy the mind of one skilled in the art who is presented only with the references, and who is normally guided by the then-accepted wisdom in the art.”⁴⁵ The inquiry is not whether the differences themselves would have been obvious, but whether the claimed invention as a whole would have been obvious.⁴⁶

⁴¹ Chisum, Donald S., et al., *Principles of Patent Law* at 532 (3d ed. 2004).

⁴² *In re Rouffet*, 149 F.3d 1350 at 1357 (Fed. Cir. 1998).

⁴³ *In re Vaeck*, 947 F.2d 488 at 493 (Fed. Cir. 1991).

⁴⁴ Chisum, et al. at 624.

⁴⁵ *W.L. Gore & Associates, Inc. v. Garlock, Inc.*, 721 F.2d 1540, cert. denied, 469 U.S. 851 (1984).

⁴⁶ *Stratoflex, Inc. v. Aeroquip Corp.*, 713 F.2d 1530 (Fed. Cir. 1983).

A Person of Ordinary Skill in the Art. This hypothetical person of ordinary skill is described by the Federal Circuit Court of Appeals as “a hypothetical person who is presumed to be aware of all the pertinent prior art.”⁴⁷ While this all-knowing person may be a bit difficult to find, the Court also notes that the person of ordinary skill “thinks along the line of conventional wisdom in the art and is not one who undertakes to innovate, whether by patient, and often systematic research or by extraordinary insights.”⁴⁸ In tax, such a person of ordinary skill would presumably be a CPA or lawyer with an average education, who is knowledgeable of the conventional wisdom in income tax planning, estate planning, sales and use tax planning or other tax area and the of planning strategies to reduce or defer taxes or change the nature of the tax paid.

The Level of Ordinary Skill in the Pertinent Art

The third factual inquiry analyzes the level of ordinary skill in the pertinent art. “Factors that may be considered in determining level of ordinary skill in the art include (1) the educational level of the inventor; (2) type of problems encountered in the art; (3) prior art solutions to those problems; (4) rapidity with which innovations are made; (5) sophistication of the technology; and (6) educational level of active workers in the field.”⁴⁹ Additionally, references that do not qualify as prior art, because they either postdate the claimed invention date or were not widely

⁴⁷ *Custom Accessories, Inc. v. Jeffrey-Allan Indus., Inc.*, 807 F.2d 955, 962 (Fed. Cir. 1986).

⁴⁸ *Standard Oil Co. v. Am. Cyanamid Co.*, 774 F.2d 448, 454 (Fed. Cir. 1985).

⁴⁹ *Environmental Designs, Ltd. v. Union Oil Co.*, 713 F.2d 693 at 696 (Fed. Cir. 1983), *cert. denied*, 464 U.S. 1043 (1984).

disseminated, may nonetheless be utilized to demonstrate the ordinary skill in the art at the time the invention was made.⁵⁰

As the legal analysis indicates, analyzing a patent application for nonobviousness is not a simple, straight-forward process. There are a number of critical determinations that need to be made, none of which are mechanistic in their application. However, it is this very lack of mechanistic rules that require patent examiners to have a thorough understanding of tax practice and the use of sophisticated tax planning strategies by persons of “ordinary skill.” The flexibility inherent in the analysis, the ability to combine references and to use references that post-date the patent application to demonstrate that a patent’s claims would have been obvious to a person skilled in the art would appear to require a level of tax knowledge that most patent examiners simply don’t possess.

APPLYING NOVELTY AND NONOBVIOUSNESS TO TAX STRATEGY PATENTS

In this section, we examine evidence of prior art in order to determine whether the tax strategy patents identified by Chumney et al. appear to meet the novelty and nonobviousness requirements of the patent law.

Patent No. 6,567,790

The SOGRAT patent was applied for on December 1, 1999 and granted on May 20, 2003. As noted earlier, in order to determine whether a patent is obvious, three primary factual inquiries must be made: (1) determining the scope and content of the prior art; (2) ascertaining the differences between the prior art and the claims in issue; and (3) resolving the level of ordinary skill in the pertinent art.

⁵⁰ *Ex parte Erlich*, 22 USPQ 1463 (Bd. Pat. App. & Inter. 1992); *National Steel Car Ltd. v. Canadian Pacific Railway Ltd.*, 357 F.3d 1319 (Fed. Cir. 2004).

In this case, there appears to be sufficient relevant prior art that is directly on point to question the validity of the patent. The use of stock options to fund grantor retained annuity trusts appears to have been used by CPAs and lawyers prior to the date the patent was applied for and granted. The stock option GRAT was discussed in an online ABA discussion thread from September 1998,⁵¹ more than one year prior to the date of the application for patent. The strategy was also discussed at the Chicago-Kent College of Law 21st Annual Federal Tax Institute on May 3, 2002 in a presentation by George Dionisopoulos and Michael Woolever who also claim use of the technique for a client in 1998.⁵² While this presentation was made after the application date and is not relevant in determining whether the patent was novel, these references may still be utilized to demonstrate the ordinary skill in the art at the time the invention was made. It appears clear that sufficient knowledge existed at the time of the patent application that individuals of ordinary skill would have been capable of making the claimed composition or device.

When planning for a client with a potential estate tax liability, depending on the specifics of the client's situation, an estate planner would likely consider a variety of estate planning strategies including taking advantage of available exclusion amounts and generation-skipping tax exemptions, the use of lifetime gifts, irrevocable life insurance trusts, charitable giving, family limited partnerships (FLPs), dynasty trusts, intentionally defective grantor trusts, self-canceling installment notes, private annuities and other strategies including grantor retained annuity trusts. If a GRAT is in this mix of possible estate planning strategies, the next question faced by the planner is how the GRAT should be funded, that is, what type of property held by the client

⁵¹ <http://mail.abanet.org/scripts/wa.exe?A2=ind9809&L=aba-tax&D=1&O=D&F=&S=&P=36570>

⁵² Email from George Dionisopoulos to Eileen Sherr, American Institute of Certified Public Accountants, July 15, 2007.

would be appropriate to fund the GRAT. Depending on the portfolio of investment securities and other assets held by the client, it is reasonable to conclude that a person of ordinary skill would consider the use of stock options to fund the GRAT.

Patent No. 6,292,788

Patent No. 6,292,788, filed on December 3, 1998 and issued on September 18, 2001, makes use of real estate investment instruments adapted for performing tax-deferred real estate exchanges. The patent describes a portfolio of real estate investments that are divided into tenant-in-common deeds that are subject to a master agreement and master lease to form “deedshares.” Holders of deedshares receive a guaranteed income stream from the master lease and yearly depreciation without having to maintain or manage real estate and are eligible for tax-deferred treatment under Section 1031 of the IRC.

Section 1031 of the IRC provides for the tax deferral of gains on the exchange of property held for productive use or investment. In 1984, the code section was amended to disallow the use of like kind exchanges for partnership interests. However, it was uncertain as to whether a group of investors that purchased real estate as tenants in common (and included agreements to jointly control the property and jointly maintain the property) would be considered a partnership by the IRS. In Revenue Procedure 2000-46 (issued on 10/12/2000), the IRS revised its annual list of areas in which it will not issue advance rulings or determination letters to include questions of whether an undivided fractional interest in real property is an interest in a separate tax entity ineligible for tax-free exchange treatments under Code Sec. 1031(a)(1) noting that the IRS would study the issue further. On March 19, 2002, in Rev. Proc 2002-22, the IRS removed the question from its list of “no-rule” questions and set out the conditions under which taxpayers could obtain rulings in this area including that “each of the co-owners must hold title

to the property ... as a tenant in common under local law.” The patent claims to create a new type of investment interest called a deedshare that “represents both a tenant in common interest in real estate, and provides the divisibility and liquidity of a traditional security such as a bond.” The patent then describes a series of steps necessary to create and manage the new instrument. It is difficult to tell whether the new instrument is sufficiently different from a traditional tenant in common interest to warrant a patent.

Although both applicable Revenue Procedures were issued after the date the patent application was filed, Rev. Proc. 2000-46 was issued before the patent was granted indicating that the IRS was aware of the desire to use tenant in common interests in like kind exchanges and was studying the issue more thoroughly. While this knowledge may have been a result of the patent application, it is more likely that the use of various types of tenant in common interests had been proposed or used by other taxpayers at the time, implying that those of ordinary skill were already using or were capable of making the claimed composition or device.⁵³

Patent No. 7,149,712

This patent, filed on December 23, 2004 and issued on December 12, 2006, relates to a method and system for investing long term assets of private and public foundations and nonprofit organizations such as 501(c)(3) tax exempt charities. The allowed claims in the patent include the use of the method for charitable trusts, pooled income funds, charitable gift annuities, charitable lead trusts, permanent endowment funds and other entities. The patent also claims a method for financing the future needs of an individual through the use of variable annuities and parties such as funeral homes, cemeteries and funeral trusts.

⁵³ The publication of Rev. Proc. 2002-22 after the patent grant date is troublesome in that it provides a strong signal to taxpayers that using tenancy in common interests as replacement property is acceptable in Section 1031 exchanges. However, to the extent that Patent No. 6,292,788 is valid, this technique may be limited.

A press release issued by the inventor claims that the patent uses variable annuities in a process that “enables endowment funds to be invested in mutual funds for maximum growth potential, create a 5% annual cash flow and have the original principal insured against market loss.”⁵⁴ The press release then describes the steps that a charitable 501(c)(3) entity would need to take in order to secure the benefits of the patent.

1. Secure an annuitant (preferably between the ages of 68 and 72) who is willing to support the charitable cause.
2. Purchase an annuity contract with a guaranteed death benefit naming the charity as the owner and beneficiary and the donor as the annuitant.
3. Invest the donated funds in mutual funds or other investments of acceptable risk.

As a result of this strategy, the charity will be entitled to an annual cash withdrawal (of at least 5%) and at the death of the annuitant, the contract will pay a lump sum of either the guaranteed death benefit or the cash value of the mutual funds (whichever is higher) to the charity.

Books, articles and IRS rulings discuss the use of annuities by charitable remainder trusts well before the patent application date. For example, Private Letter Ruling (PLR) 9009047 issued by the IRS in December 1987 and Technical Advice Memorandum (TAM) 9825001 issued by the IRS in July 1988 both allow a charitable remainder trust to invest in variable annuities. In the TAM, the IRS approved an arrangement whereby the trustee of a charitable remainder unitrust invested trust assets in two tax deferred annuity contracts for the purpose of controlling the timing and amount of trust income distributions.

According to the Planned Giving Design Center (PGDC), a 1991 book titled *Harnessing the Power of the Charitable Remainder Trust* written by Marc D. Hoffman discussed and

⁵⁴ Press Release issued by Alan J. Lang, January 3, 2007.

commented on this technique. A later article published in 1999 by the PGDC also discussed the availability and benefits of using variable annuities to defer income in CRTs.⁵⁵

The authors are not aware of any prior art dealing with the use of variable annuity contracts with funeral homes, cemeteries or funeral trusts. However, it appears clear that sufficient prior art existed at the time of the patent application that individuals of ordinary skill would have been capable of making the claimed composition or device.

Patent No. 7,219,079

This patent creating a convertible financial instrument with contingent payments was applied for on August 12, 2002 and granted on May 15, 2007. The inventors claim methods and the creation of a convertible debt instrument that “through their provisions ... brings about successful market transactions that would otherwise not be possible,” as well as methods and systems for offering and servicing the same. The financial instrument would allow issuers the ability to “deduct an amount for tax purposes that more closely resembles the true economic cost of the financial instrument,” and “may tend to provide some holders with incentives that may tend to make such holder more likely to keep the instrument outstanding.” Other embodiments would provide issuers with “an increased amount of flexibility and control over the period of time the instrument remains outstanding, while potentially minimizing the normal interest due or paid to the holder.”

Several articles in addition to IRS Revenue Ruling 2002-31 discussed the use of contingent interest convertible debt as early as January 2002, at least 9 months before the patent application date. For example, in an article published in the Journal of Taxation of Financial Institutions, Dixon states that “promoters suggest that with recently popular convertible

⁵⁵“IRS Approves Income Deferral CRT Funded With Tax Deferred Annuities,” <http://www.pgdc.com/usa/item/?itemID=57991>, Wednesday, March 17, 1999.

securities, issuers may deduct interest payments at rates higher than are typical with traditional contingent debt instruments.” The author points out that in early 2002, these instruments were very popular with institutional investors, but at that time, carried a high level of tax risk to issuers.⁵⁶ In Notice 2002-36, 2002-1 CB 1029, May 6, 2002, the IRS announced its release of Rev. Rul 2002-31, 2002-22 IRB which provided guidance on controversial tax treatment under Code Sec. 1275 of contingent convertible debt instruments. An article published online on CFO.com in May 2002 notes that the ruling confirms that contingent convertible bonds constitute contingent payment debt instruments and allows issuers to receive favorable tax benefits.⁵⁷ While the patent provides systems and methods for offering and servicing the contingent interest convertible debt instruments, the patent appears to claim the creation of the convertible financial instrument itself. Once again, it appears that ample discussion of the instrument existed prior to the application date of the patent and that individuals of ordinary skill were already using the claimed composition or device in a public fashion.

Patent No. 7,096,195

Patent No. 7,096,195 was filed on July 31, 2000 and granted on August 22, 2006 and is described as a “method for enhancing the equity of a business entity.” The patent claims to do this by joining a debt instrument called a share bond to a share of equity in order for payments to the shareholder to be classified as deductible interest rather than a nondeductible dividend. The patent claims that “the Share Bond is unique in that it provides: (1) the capability of shareowners to simultaneously receive the benefits of both a bond and a stock, while purchasing only the stock, (2) the capability for the shareowner of record to receive the benefits of the Share Bond

⁵⁶ William S. Dixon, *Do Contingent Interest Convertible Debt Instruments Work as Advertised? Probably Not*, *Journal of Taxation of Financial Institutions*, Vol. 15, No. 3, page 5 (January/February 2002).

⁵⁷ Roger Willens, *Cuckoo for Coco Puffs? Contingent convertible bonds get a tax treatment boost from a new IRS revenue ruling. But the window of opportunity may slam shut*, CFO.com, accessed on 9/25/2007 at http://www.cfo.com/printable/article/cfm/3004760/c_2984376?f=options.

for the price of zero, (3) no taxable event at issue since the Share Bond is not a property and is more accurately stated as the shareowner being the receiver of benefits, (4) stock enhancement that no other bond can provide since all other bonds are investment securities for raising money, (5) a primary purpose of enhancing stock and must be joined to divisions of equity to function, (6) the only economically feasible means that stockowner of outstanding or previously issued stock can receive a guaranteed payment and payments that are not subject to double taxation, (7) allows a corporation that sells stock or equity with a debt instrument issued to the share to have the option to mature or redeem the debt instrument early without penalizing the stock in the future, because another debt instrument can be issued to the now outstanding stock or equity without in being a taxable event to the shareholder.”

There is no prior art describing this invention for the simple reason that the strategy most likely does not work. Cummings (2007) notes that there are serious questions concerning how the IRS would view the share bond described in the patent. If the share bond is viewed as debt, Cummings argues that there is “no question that distributions of a corporate debt obligation with respect to stock is a section 301 distribution” of property.⁵⁸ However, the share bond might be viewed as a distribution of preferred stock. If this is the case, Cummings notes that while the distribution itself would not result in recognition of income, when the stock is sold, both the stock and the share bond would be sold together and that part of the sales price allocated to the share bond might be treated as a dividend under section 306. Under section 306(a)(2), a redemption of section 306 stock is treated as a distribution of property to which section 301 once again would apply. The bottom line is the claimed tax benefits of the share bond are likely to be disallowed by the IRS.

⁵⁸ Jasper L. Cummings, Jr., *Tax Strategy Patents*, 115 Tax Notes 263 (April 16, 2007).

CONCLUSION

The discussion above suggests that none of the patents reviewed in this paper that have been pejoratively labeled tax strategy patents were unknown at the time of the issuance of the patent. Using the obviousness standard, it appears that at least some of the aforementioned tax strategy patents made use of tax avoidance techniques generally known to tax advisors at the time of application. Whether the tax strategy patents reviewed here will be able to withstand a validity challenge in court is a matter of speculation.