House Committee on Ways and Means

Statement of The Honorable Mark Everson, Commissioner, Internal Revenue Service

Testimony Before the Subcommittee on Select Revenue Measures
of the House Committee on Ways and Means

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Introduction

Chairman Camp, Ranking Member McNulty and members of the Subcommittee, I am happy to be here this morning to address the issue of patenting tax strategies including potential tax shelters. This is an issue with which we have become much more familiar in recent years and have worked with the United States Patent and Trademark Office (USPTO) as more patents have been granted for tax products.

Framing the Issues

As the Subcommittee focuses on the larger issue of tax patent strategies (TPSs), I think it is important to properly frame the issue and understand IRS' role or lack thereof in the patent process.

First, we need to draw a distinction between the granting of patents to tax products or strategies that are in compliance with the tax laws, and to abusive tax shelters or other products that may not be. On the one hand, the ability to obtain a patent could encourage the development of products to help people comply with the tax law, similar to other protections of commercial interests such as trademarks and copyrights.

Our operating philosophy at the IRS is that service plus enforcement equals compliance. From that perspective, tax administration could in fact benefit from the granting of patents to tax products that facilitate the ability of taxpayers to plan and conduct their tax affairs in compliance with the law. For example, a patent for a novel type of tax computation software that makes filing easier could benefit many taxpayers. This category of patents is potentially helpful to our mission by encouraging needed research and innovation by the private sector.

Second, we recognize that there are substantial policy issues as to whether or not business methods involving tax strategies or products should be granted protection by the government. Granting patent protection to such strategies could limit the use of that particular tax strategy by other taxpayers and have a negative impact on their ability to comply with the tax law.

While the policy issues are significant, many are outside IRS' jurisdiction and field of expertise. Importantly, the granting of a patent on a tax strategy provides protection to the patent holder against infringement by other parties, but has no bearing on its legitimacy or illegitimacy under the tax laws, which remain under the jurisdiction of the IRS.

Unlike a private letter ruling, a pre-filing agreement, or an advance pricing agreement, a patent carries with it no assurance whatsoever that the patented process, transaction or structure will pass IRS muster. We are concerned, however, that taxpayers may be confused about this and may view a patent as a government seal of approval of all aspects to which the patent pertains, including the tax aspects.

We understand that some developers of tax-related patents may advertise and promote their "patented" concepts to the general public. We are currently considering ways to reduce the risk of taxpayers mistakenly believing that the issuance of a patent is indicative that the IRS has approved the particular technique being marketed.

Just so there is no misunderstanding today on this point, let me be clear. The grant of a patent for a tax strategy has absolutely no impact on IRS' determination of the effectiveness or the legitimacy of the strategy under tax law. The IRS will issue a policy statement that will make this clear to all taxpayers.

Third, we recognize that taxpayers may attempt to patent abusive tax schemes. As I will discuss later, however, we have not seen such an abuse in our review of existing tax patents.

Finally, patented tax strategies place an increased burden on practitioners who, while simply developing good gift, estate or business planning strategies for their clients, would be obligated to conduct "due diligence" searches for existing patents on such strategies.

I will talk later about the patent searches that the IRS has done from the USPTO public data base. That experience has taught us that patent searches can be cumbersome and time-consuming. This burden is accentuated if a patent has been granted for a commonly used "tried and true" technique within a field. In these cases, a practitioner who wishes to use a standard planning technique could expose himself and his client to potential liability for royalties or infringement litigation.

As you can see, tax-related business process patents raise issues for the IRS. They raise even more complex policy issues for others.

I would now like to discuss what we have done and are doing to monitor tax patents as well as how we are working with the USPTO. The point of this work has been three-fold: first, to use the USPTO databases as another potential source of information about the marketing of abusive tax schemes; second, to detect whether patents are being used as a way to avoid other characteristics the IRS has identified as indicating potentially abusive transactions; and third, to assist the USPTO in carrying out its mission.

Patent Reviews

IRS's principal interest in patented tax strategies is in determining whether promoters are patenting abusive tax avoidance transactions (ATATs).

To that end, in 2004 and 2005 we performed two searches of the more than 6.5 million patents in the USPTO data base. The first search, conducted in November 2004 was designed to identify patents and public applications of known tax shelter strategies, specifically of IRS transactions identified as "listed" transactions in Notices 2004-67, which is the list of thirty transactions that have been determined by the Internal Revenue Service to be "listed transactions" as of October 12, 2004, and Notice 2005-13 which listed another transaction on February 28, 2005. That search, which was updated in November 2005 and again in June 2006, found no evidence of patents or public patent applications embodying any of the abusive tax shelters or listed transactions.

A second type of search was conducted in July 2005 and is updated periodically. The goal of this search was to measure the occurrence and type of business patents that might involve tax strategies. The initial search just asked for patents that included the word "tax" in applications and granted patents in all classifications. Of the 6.8 million patents in the USPTO data base we had fewer than 300 "hits". A

further analysis showed that approximately 100 of these dealt with "Business methods" and the majority of those appeared to be software models for computing tax impact or effect, and not tax strategies.

We were left with 14 patents and applications primarily in the areas of employee compensation, wealth transfer, and financial products. Upon initial examination, none of the 14 patents were found to be abusive tax avoidance transactions. We have subsequently completed our review of 12 of the 14, one of which was allowed by the applicant to expire for non-payment of fees. While we do not consider them to be ATATs, we are continuing to review two of the transactions to fully satisfy ourselves that they do not present compliance risk requiring follow up action on our part. Ultimately, we often need to see a real world example of how the transaction is carried out before we can be confident that the transaction is not abusive

Based on this analysis, we thus far have not seen the use of the patents in developing or marketing aggressive or abusive tax strategies, but we continue to monitor on a quarterly basis the USPTO tax patent data base.

Working with the USPTO

Since 2004, we have been working with the USPTO to help it address concerns about patents granted. Specifically, we formed a task force with members from both agencies to establish the scope of our effort. Last summer, we conducted a cross-Agency workshop which encompassed topics requested by the USPTO. This was an awareness workshop and was similar to what industries have historically done with the USPTO to keep them abreast of the latest sources of information, trends in practice, and the like. Our goal was to assist the USPTO in developing the resources to determine "prior art" in the area of tax strategies and structures.

The prior art doctrine is a cornerstone in the patent application examination process. Under this doctrine, a patent application should be rejected if the subject matter is neither new nor original.

IRS does not consult with the USPTO in the review of "prior art". Our contribution to this process would be tangential to our core mission. Moreover, if the IRS were to have a special or official role in evaluating the novelty and non-obviousness of a patent, this might be mistaken for IRS approval of the strategies or structures being patented.

There are also significant confidentiality restrictions on both agencies that could hinder a cooperative effort in the review or prior art. As a result, USPTO must instead rely on input from the practitioner and other stakeholder communities to develop a reliable profile of what qualifies as prior art.

Practitioners are generally the creators of business methods and tax strategies. As they have raised concerns, the IRS has encouraged practitioner organizations, such as the American Bar Association and the American Institute of Certified Public Accountants, to play an active role in supplying the USPTO with useful information on business methods for consideration as prior art.

We have also offered USPTO ideas on how to ferret out a tax strategy during a patent examination. USPTO has also created a classification category dedicated to TPSs. This is a sub-classification (36T) of Business Method Patents dedicated to tax strategies. In March 2006, we began quarterly monitoring of this TPS sub-classification.

In addition, we consulted with the USTPO in the development of a protocol to allow patent examiners, once it is determined that the patent has a tax aspect, to request that patent applicants reveal specific

Internal Revenue Code regulations and procedures affected by a patent application.

These steps should not only make it easier for the IRS to track patents of tax strategies and structures, but it should help tax professionals identify these patents for whatever purpose.

Conclusions

In conclusion, Mr. Chairman, the cooperative efforts between the USPTO and the IRS have resulted in significant strides in monitoring and reviewing tax strategy patents. Transparency of these types of patents has increased; USPTO examiners have a broader base of knowledge on which to assess patent applications; and the IRS has benefited by gaining an understanding of the patent process and the rights a patent bestows on its owner. This latter point is a key factor in valuation issues addressed by IRS examiners such as donations made under prior law, off-shore transfers, and arm's length consideration for patents.

We recognize that some patents or trademarks actually benefit both taxpayers and the IRS in that they protect techniques that ease the compliance burden on taxpayers and may lessen the enforcement load of the IRS. In addition, while the IRS has worked to gauge the impact of patented tax strategies and structures on compliance and administration, we have found little evidence to suggest that tax shelters or aggressive tax avoidance transactions are being patented. But we recognize that the potential for significant problems could exist.

While patenting tax strategies and structures make the transactions more transparent, there are several negative by-products to this process. First, we believe that the public may be largely unaware about both the rights that a patent owner enjoys and the fact that a patent does not guarantee that the transaction has the desired tax consequences. Let me repeat what I said earlier: a patent for a particular technique carries no weight with the IRS in assessing compliance with tax laws and regulations.

Second, we believe that the trend toward increased patents of tax strategies and structures places an increasing burden on tax professionals. They must do an extensive search of the USPTO data base to determine if a particular strategy is protected.

We will continue to work with the USPTO in targeted areas. We also strongly encourage the practitioner community to take an active role in assisting the USPTO in addressing developing issues with this evolving area of patent law.

Thank you again, Mr. Chairman for the opportunity to be here and I will be happy to respond to any questions that you may have.