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Keeping Your Enemies Closer: Revolutionizing Tax Law and Enforcement with Intellectual Property Rights

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Keeping Your Enemies Closer: Revolutionizing Tax Law and Enforcement with Intellectual Property Rights

Alidad A. Damooei*

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INTRODUCTION

In recent years politicians have spoken frequently about tax reform. During the 2012 presidential campaign, both Democrats and Republicans discussed the need for change in this area.1 During his second term, President Barack Obama has urged Congress to close the “loopholes” in the Internal Revenue Code (“Code”).2 Ultimately, any tax reform will involve difficult changes that will create both winners and losers.3 But there is one source of tax revenue loss that few straight-faced policymakers can justify: abusive corporate tax shelters.

Abusive corporate tax shelters seize upon unintended loopholes in the dense jungle of formalisms that comprise the Internal Revenue Code. They have deprived the Treasury of significant revenue over the years. At the height of the corporate tax shelter boom, the Clinton Administration estimated that the Treasury was losing $10 billion a year.4 One IRS contractor estimated that the cost in one year was in the range of $14.5 to $18.4 billion.5 The Internal Revenue Service (“IRS”), Department of the Treasury, Department of Justice (“DOJ”), and Congress all have tried to deter such abuses. Policymakers have strengthened penalties on taxpayers and their advisors in order to discourage abuse. These efforts have helped but there are better ways to combat abuse.

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3. For instance, there may be strong efficiency justifications for ending programs like the home interest deduction, but such changes will be painful and unpopular. Diverse parties ranging from real estate developers to ordinary homeowners would face short-term financial harm.
5. Id.
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Policymakers have often considered strengthening penalties on taxpayers and their advisors in order to discourage abuse. This focus is sensible. Higher penalties on advisors, in particular, would add a useful weapon to the government’s arsenal. The traditional paradigm, which focuses only on the incentives of taxpayers and treats them as the sole gatekeeper of their tax return, leaves largely untouched the substantial economic rewards that accrue to tax advisors. Accordingly, this Note focuses on advisor incentives and shows that carrots can complement sticks. Specifically, this paper sketches out a new tax shelter patent device that would revolutionize the interconnected relationships between taxpayers, advisors, and the government.

Abusive tax shelters are designed, distributed, and driven by promoters who have superior information about the risks of a tax product. The traditional tax advisory framework does not apply to abusive corporate tax sheltering. Under this traditional framework, taxpayer needs drive the relationship: a tax advisor reviews the business needs and transactions of a taxpayer to find ways in which that individual or entity could reduce their taxes. Complex tax shelters turn this paradigm on its head because they are designed, distributed, and driven by promoters who have superior information about the risks of a tax product. The advisor’s tax trick precedes the taxpayer’s business needs. Tax experts pore over the Code to identify obscure gaps in the law and then develop transactional structures that exploit these gaps. Once they have perfected their concept, they rush to the market with this pre-packaged product and work with taxpayers to find an ostensible business purpose for a transaction that fits the preconceived shelter framework.

Tax advisors drive the process and, as such, policymakers need to focus on their incentives. The Code features several penalties that try to manage these incentives, but this patchwork of provisions has failed to adequately deter abuse. The greatest shortcoming of the existing tax shelter enforcement is that it is reactive. The government is perpetually one step behind the latest abusive tax shelter. Abusive shelters follow a predictable life cycle. First, the government promulgates a law or regulation. Sophisticated experts then look at the new rules to see if there are any gaps that allow legitimate or abusive sheltering. If a weakness is detected, promoters perfect a transaction structure to manipulate the law and then market that idea to taxpayers.

At this point, the ball is in the government’s court. In the best-case scenario, the government learns about the abuse through lengthy and expensive corporate tax return audits. If possible the government claws back understated taxes and penalties. And, most importantly, policymakers change the laws and regulations

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7. Rostain, supra note 4, at 90.
to close that specific loophole. In the worst case scenario, the government never learns about the abuse and the tax base is stealthily eroded.

The government has tried to get ahead of the ball by expanding tax shelter disclosure requirements. Although these reforms have helped, they leave much to be desired and still create space for new and aggressive tax shelters. Moreover, the penalties that reinforce these requirements are only as effective as the government’s limited ability to detect abuse.

This Note focuses on advisor incentives and shows that carrots can complement sticks. Specifically, this Note sketches out a new tax shelter patent device that would revolutionize the relationships between taxpayers, advisors, and the government. This tax shelter patent would provide tax advisors a financial incentive to rush to the government—rather than to taxpayers—when they discover a failure in the Code. The information gleaned from such disclosures will improve abusive tax shelter regulation. Such information can facilitate a well-coordinated response to a specific abusive tax shelter by different government actors. Congress can use it to amend the tax laws. Treasury department policymakers can use it to update regulations and listing requirements. And the IRS can use it to audit corporate tax returns more effectively.

Unfortunately, tax law and patent law have not mixed well in recent years. Congress banned all patents on tax strategies in the America Invents Act in 2011. Debate over the Act focused mostly on the effect of such patents on the incentives

10. See, e.g., 26 C.F.R. § 1.6011-4(b) (2013).
to develop new tax minimization strategies. There was some limited appreciation of the fact that patents could facilitate some disclosure but, in reality, there was little disclosure of abusive tax sheltering activity. Neither opponents nor proponents of tax strategy patents considered how to effectively use patents to incentivize disclosure of new tax minimization strategies.

The failure of policymakers to adequately consider how to cultivate disclosure suggests the need to reconsider the complete ban. Congress needs to revisit this decision sooner rather than later while the debate is still somewhat fresh. The longer it waits, the more inertia will make it harder for Congress to reverse course. This Note steps into the gap that marked the policy debate and proposes a special patent device that would maximize disclosure. The proposed paradigm justifies a second look at the complete ban.

A tax shelter patent could include many common features of patent law, but it should include three special features. First, it is critical that tax shelter patentees have a limited and defined immunity to use or license their tax shelter. Immunity will encourage tax shelter engineers to come out of the shadows. Second, the Treasury Department—not the Patent and Trademark Office (“PTO”)—needs to administer tax shelter patent applications. This would streamline the process by which information from patent applications can reach Treasury officials responsible for tax shelter enforcement and policy. This is also necessary because the PTO was not able to effectively manage tax strategy patents. Third, individual taxpayers who earn below a certain threshold of income (and their advisors)


15. Moulton, supra note 13, at 238-39 (describing an IRS review of millions of patents which concluded that not a single one involved a listed transaction).

16. THOMAS, supra note 13, at 14; Closson, supra note 13, at 170.
should be immune from tax shelter patent liability. The proposed tax shelter patent is designed to tackle abusive corporate tax shelters and it is unnecessary for it to entangle the vast majority of taxpayers who do not have the means to utilize such shelters.

This Note is divided into two principal Parts. Part I sets forth a comprehensive history of modern abusive corporate tax shelters. This provides the background necessary to appreciate the benefits of a special tax shelter patent regime. Part II then describes the contours of a special tax shelter patent. This exposition discusses the controversy surrounding traditional tax strategy patents and sets forth the principal benefits of reintroducing some intellectual property rights in the tax law context.

I. History of Abusive Corporate Tax Shelters

This Note proposes a tax shelter patent that is tailored to the dynamics of the tax shelter industry. In order to appreciate the cure one must understand the disease. This Part presents the history of abusive tax shelters over the last three decades, and outlines how the tax shelter industry operates and the forces that generate a demand for and supply of such schemes. The Note then describes the government’s response and argues that there is still more that needs to be done.

A. What Is an Abusive Corporate Tax Shelter?

Creative minds have always found ways to manipulate the complexities of the Code. This Note focuses on a breed of abusive corporate tax shelter schemes that emerged in the 1990s. These devices reached new heights of complexity and sophistication as elite accountants, lawyers, and bankers began developing such products for large corporate clients.

It is difficult to formulate an all-encompassing definition of abusive corporate tax shelters, but Tanina Rostain explains that they generally share three characteristics:

First, the transaction creates a tax loss through an investment with little financial risk and no significant potential for profit. . . . Second, the transaction involves a domestic corporation and a tax indifferent party and permits the allocation of income, in excess of economic income, to the tax indifferent party, leaving a loss, in excess of economic loss, to the domestic taxpayer; alternatively, the transaction exploits other structural flaws in the U.S. tax system or discrepancies in the interaction between the U.S. and other systems. Third, the transaction has not been

developed for a single taxpayer but has been designed by a promoter to be marketed to Fortune 500 or large, closely-held corporations.\textsuperscript{18} Donald Korb, the former Chief Counsel of the IRS, explains that another common characteristic of such schemes is a “convoluted” transaction structure.\textsuperscript{19} This characteristic complexity makes it hard for the government to detect abuse. Fundamentally, such devices are appealing to corporate taxpayers because the questionable tax losses generated in these transactions can offset real economic income generated by its business operations.

The IRS, Treasury Department, Congress, and the courts were all caught off guard by the creativity and aggressiveness of abusive corporate tax shelters. These institutions began to react in the late 1990s.

B. What Caused the Abusive Corporate Tax shelter Boom?

Three powerful forces combined to create a perfect storm in which abusive corporate tax shelters thrived. Economic and technological innovation helped create the demand for and supply of such devices, and a weak regulatory environment was unable to initially perceive and respond to the growing problem. And, most importantly, an aggressive industry of sophisticated advisors emerged willing and able to seize upon the situation.

1. Economic and Technological Forces

The 1990s were a decade of economic growth. Private sector success generated large capital gains from the sale of stock, real estate, and other assets.\textsuperscript{20} This naturally generated an appetite for shelters that create the appearance of tax losses to mask economic income.\textsuperscript{21} Technological innovation also generated sophisticated financial products that had complicated—and easy-to-manipulate—tax consequences.\textsuperscript{22} Financial innovation made it easier to disentangle the economic risks of a deal from its tax implications.\textsuperscript{23} Tax rate minimization blossomed into a competitive sport as corporate tax departments acted like profit centers rather

\textsuperscript{18} Rostain, supra note 4, at 84.


\textsuperscript{20} See Rostain & Regan, supra note 17, at 9.

\textsuperscript{21} See Mark S. Pincus, Circuit Split or a Matter of Semantics? The Supreme Court’s Upcoming Decision on Rule 10b-5 “Scheme Liability” and Its Implications for Tax Shelter Fraud Litigation, 76 FORDHAM L. REV. 423, 428-29 (2007).


\textsuperscript{23} Rostain & Regan, supra note 17, at 13.
than mere compliance offices. The heady financial climate created both the demand for and supply of abusive corporate tax shelters.

2. Weak Regulatory Environment

Powerful economic and technological forces came together in an environment of lax tax regulation and enforcement. There were serious problems with both resources dedicated to enforcement and the laws guiding such efforts in the 1990s. The IRS was understaffed and unable to effectively detect abusive tax shelters. Between 1996 and 2001, the number of corporate tax return filings increased as the IRS staff was cut, which led to a 38 percent decrease in the audits of companies with more than $250 million in assets. When an audit did occur, the IRS took on average five years after the corporation filed its tax return to start its audit.

To make matters worse, the IRS adopted a less aggressive enforcement culture as congressional hearings in 1997 questioned its overzealous investigation of individual taxpayers. It would take several more years until Congress came to truly appreciate that there was a serious abusive corporate tax shelter problem that required a stern—although ultimately imperfectly executed—response.

The shortcomings of the regulatory environment had a real, discernible impact. Michael Hamersly, a KPMG whistleblower, testified before Congress that his firm operated under two important assumptions when promoting tax shelters: the IRS lacked the resources to discover tax shelters and that, if it did discover them, penalties would be minimal. Emails corroborated Hamersly’s allegations. One KPMG partner wrote to a colleague comparing the costs and benefits of promoting a particular abusive tax shelter: "our average deal would result in KPMG fees of $360,000 with a maximum penalty exposure of only $31,000." At most, penalties simply justified higher fees. The head of KPMG's national tax office wrote in another email about

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25. Pincus, supra note 21, at 428.
26. Rostain, supra note 4, at 87.
27. Id.
28. Michael Graetz describes how Senate Republicans channeled populist anger against the agency’s tax collection efforts in the late 1990s. Graetz, supra note 24, at 36-39. He argues that such criticism influenced the IRS to “convert from an ‘enforcement’ to a ‘service’ agency.” Id. at 38.
30. Id. (statement of Michael Hamersly).
a potential shelter: "[W]e should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit." 35

3. The Central Role of Advisors in an Aggressive Industry

KPMG was not alone as audacious enterprises emerged in the blind spots of tax law and enforcement. Prestigious entities across diverse industries like accounting, investment banking, and law entered the abusive tax shelter industry. There are two major steps in promoting such tax products: development and marketing.

Abusive corporate tax shelters are usually not developed by taxpayers. Sophisticated professionals identify "obscure provisions of the Code, new financing devices, and esoteric legal forms that could be combined to develop innovative products." 35 Tax advisors do not develop these devices after consulting a specific client and learning about their business needs. Rather, tax shelter promoters first identify the tax gimmick, and then business goals are studied after the fact in order to give the sheltering transactions an ostensible business purpose. 36

Developing a shelter has high fixed costs, and the best way to recoup these costs is selling a shelter to multiple clients. 37 Tax promoters rush to the market once they devise an abusive shelter, sometimes going so far as to telemarket to potential clients. 38 Competition can be fierce since new ideas spread quickly through industry gossip and reverse engineering. 39

Two cases illustrate the pathologies of the abusive corporate tax shelter industry: Long Term Capital Holdings v. United States 40 and ACM Partnership v.
These cases demonstrate the central role that advisors play in the abusive tax shelter context. Advisors and their tax tricks lead the dance—not the taxpayer and their business needs.

Babcock & Brown ("Babcock")—a now-defunct international investment firm—developed, marketed, and facilitated the tax shelter in *Long Term Capital Holdings.* The shelter was very complex but, at its core, it created preferred stock with a built-in loss that could then be used by a domestic entity to shelter income. Beyond the technical details of the transaction, it is important to focus on Babcock's sales efforts to understand how the abusive tax shelter industry operates. The central role of advisors demonstrates the need to focus on their incentives.

James Babcock presented the tax shelter idea to Donald Turlington, a regular tax counsel of Long Term Capital, over dinner. Babcock promised Turlington a percentage of the bank's profits on the deal. Turlington agreed and suggested the tax shelter to Larry Noe, Long Term Capital's in-house tax counsel. Noe then began working with Babcock to implement the shelter. Only after Long Term Capital appreciated the tax benefits of the proposed deal did Noe collaborate with Dr. Myron Scholes, Long Term's founder, to find "a reason independent of taxes for Long Term to engage in a transaction with the holders of the high basis preferred stock" that would generate the deductible losses.

Babcock did more than market the idea. The firm created the asset with a built-in loss through a series of transactions involving the Onslow Trading Corporation ("OTC"), a partnership formed in the Turks and Caicos Islands by three principals in the United Kingdom. Although OTC and Babcock were distinct entities, Babcock indirectly controlled OTC through an exclusive agency agreement. OTC engaged in multiple transactions to create preferred stock with a fair market value of $4 million and a claimed basis of $400 million.

Although the details of how the transactions manipulated the Code are intriguing, what is more significant for the purpose of this Note is the role different actors played in the transaction. The source of the tax loss—the high basis preferred stock—was engineered entirely through transactions directed by Babcock and its related entities. The taxpayer was simply an end-user who purchased a product with only one purpose: tax reduction.

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41. 157 F.3d 231 (3d Cir. 1998).
42. *Long Term Capital Holdings,* 330 F. Supp. 2d at 142.
44. *Long Term Capital Holdings,* 330 F. Supp. 2d at 142.
45. Id. at 132.
46. See id. at 140.
47. Id. at 128.
The central role of the tax advisor is also clear in *ACM Partnership* where the Colgate-Palmolive Company ("Colgate") used a tax shelter developed by Merrill Lynch. Merrill Lynch pitched the tax shelter idea to Colgate soon after Colgate had enjoyed a capital gain from the sale of a subsidiary.

The tax shelter involved a contingent installment notes transaction using a partnership between Colgate, Merrill Lynch, and Algemene Bank Nederland, N.V. ("ABN"). The partnership then engaged in a series of transactions over several years that enabled it to allocate tax income to ABN, a tax-indifferent foreign entity, and tax losses to Colgate. Although there was a gain and loss for tax purposes, there was no discernible economic gain or loss. Misuse of rules relating to contingent installment sales relating to section 453 of the Code enabled this outcome.

Again, the advisor, Merrill Lynch, played a significant role throughout the entire life of the tax shelter. It identified Colgate as an interested taxpayer based on its recent sale of a subsidiary and then pitched the idea. But it did more than just develop and market the strategy. Merrill found all the counterparties who traded securities with ACM and it even convinced ABN to serve as ACM's tax-indifferent partner. Indeed, Merrill Lynch went above and beyond serving as a mere advisor or broker as it formed a subsidiary that owned a stake in ACM. Although Merrill’s financial interest in ACM was small, it had to serve as a partner to ensure that ACM would not lose partnership status once ABN exited. Merrill was at Colgate’s side from the initial sales pitch through every transaction that manufactured the artificial tax loss.

*Long Term Capital* and *ACM Partnership* both demonstrate the important role that advisors play in the world of sophisticated abusive tax shelter. These cases and countless others eventually drew the attention of the government which pursued a multipronged attack that generated some successes.

C. *The Regulatory Response*

Once the government learned about the abusive corporate tax shelter boom, its response followed a familiar, patchwork routine. The IRS first began noticing questionable tax positions through audits and subsequent litigation. But IRS lit-
igation often yielded mixed results, with some questionable transactions surviving judicial scrutiny. Eventually the Department of Justice complemented the IRS efforts as it began to pursue criminal charges against powerhouse firms like KPMG. The Department reached eight and even nine figure settlements and the United States forced major firms to adopt modest changes.\(^{54}\) Congress also acted by passing a litany of statutes\(^{55}\)—a process that is still ongoing with new pending legislation.\(^{56}\) And, finally, the Treasury Department has issued regulations to supplement these statutes.

While the Tax Reform Act of 1986 put a final end to the old wave of abusive tax shelters,\(^{57}\) the dribble of legislation and regulation over the last fifteen years demonstrates that the efforts thus far have not been completely successful. The current approach of piecemeal solutions is reminiscent of the various laws passed between 1969 and 1986 that attempted yet failed to put an end to the first wave of abusive tax shelters.\(^{58}\)

This Section surveys and evaluates various attempts to combat abusive corporate tax shelters. The history illustrates that the reforms—though helpful—have not been enough and that a new paradigm is necessary. This failure to achieve a conclusive victory against abusive tax shelters suggests a need to consider a new approach—one that is less adversarial and more coordinated. A special tax shelter patent is a device that will force the IRS, Treasury, and Congress to pursue a more cohesive response to the problem with the assistance of sophisticated and well-motivated private sector tax advisors.

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1. IRS Litigation: Early Enforcement Efforts

At first, the IRS undertook its traditional strategy of auditing tax returns and challenging questionable tax treatments. As these efforts proved inadequate, legislators and regulators stiffened disclosure and list-maintenance duties. This allowed the government to target the abusive tax shelter industry at its source: accountants, attorneys, and other advisors.

In early litigation, the IRS relied on a variety of traditional doctrines, such as the economic substance doctrine, to tackle abusive shelters. These doctrines impose standards atop the rule-like formulation of the Code. The economic substance doctrine, for instance, involves a two-part inquiry into the objective economic substance and subjective business purpose of a transaction. The objective analysis focuses on whether the transaction offered an opportunity for pre-tax profit, while the subjective prong inquires into whether the purpose of the transaction was to pursue some non-tax business objective.

The IRS must often invoke the spirit of the law because sophisticated yet abusive tax shelters often conform to the letter of the law. But these standards-based doctrines are imperfect. The IRS achieved some high stakes victories like ACM Partnership, but these victories were mixed with defeats. These defeats undermined the IRS's enforcement efforts. In the face of these difficulties, the Department of Justice began to pursue advisors. But before discussing this second genre of litigation, it is important to understand the evolving legal obligations of advisors.

2. Congressional Response: The Regulation of Advisors

Over the last fifteen years, Congress has enacted several pieces of legislation to respond to the abusive corporate tax shelter problem. The new laws and their related regulations have helped by forcing increased disclosure and combating the abuses of legal opinion writers.

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60. Id. at 811-12; e.g., Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 174 (D. Conn. 2004) ("Long Term could not have had any realistic or reasonable expectation that it would make a non-tax based profit from the OTC transaction."); see Santa Monica Pictures v. Comm'r, 89 T.C.M. (CCH)1157 (2005).

61. E.g., ACM P'ship v. Comm'r, 157 F.3d 231, 257 (3d. Cir. 1998) (observing that "documents outlining the proposed transactions, while quite detailed in their explanation of expected tax consequences, are devoid of such detailed projections as to the expected rate of return on the private placement notes and contingent payment notes that were essential components of each proposal").

The most important legislative response to the abusive corporate tax shelter problem was the American Jobs Creation Act of 2004 ("AJCA"). The law expanded the legal duties imposed on advisors. Congress broadened the list-maintenance requirements of section 6112 to require that "material advisors" maintain lists of all the people who received advice in connection with a reportable transaction. The law also expanded the disclosure requirements of section 6111 to require material advisors to proactively notify the IRS about the details of certain transactions.

The AJCA also targeted legal opinion letters that had been used by taxpayers to avoid penalties. It diminished demand for questionable legal opinions by establishing that a taxpayer may not receive penalty protection from such opinions if they fail to disclose a tax shelter which is later proven to be abusive. The IRS complemented the AJCA with a revised Circular 230, which governs legal opinion letters. The modifications imposed "heightened due diligence standards and disclosure for covered opinions, and increase[d] penalties for violations including censure, suspension, fines, or even disbarment from practice before the IRS." These innovations made it harder for lawyers to write boilerplate shields against penalties. Law firms have responded to these reforms by having their client communications warn recipients that their advice may not be used to avoid tax penalties. These changes make it harder for tax shelter promoters to convince their clients that they face zero penalty risk.

3. DOJ Criminal Investigations: Expanded Enforcement Efforts

As Congress has ratcheted up the various disclosure requirements and penalty risks associated with abusive tax shelters, the executive branch has also pursued more aggressive enforcement strategies. The inability of the IRS to hold a strong line against taxpayers in early litigation demonstrated that the government had to find a new strategy. The government began to fight the problem at its source as congressional hearings shed light on the excesses of advisors. The United States began criminal investigations into the activities of major accounting firms.

63. Pub. L. No. 108-357, 118 Stat. 1418 (codified in scattered sections of 7, 26, and 42 U.S.C.);
64. Id. at 1582-83; see 26 U.S.C. § 6112 (2006).
65. GRAETZ & SCHENK, supra note 34, at 819; see 26 U.S.C.A. § 6111 (West 2010).
66. See Rostain, supra note 4, at 108.
68. GRAETZ & SCHENK, supra note 34, at 822.
69. See, e.g., Hearing Before the S. Comm. on Fin., supra note 29.
The Department of Justice accused KPMG of conspiring to defraud the IRS by developing and marketing abusive tax shelters.\textsuperscript{70} KPMG entered into a deferred prosecution agreement, acknowledging that it helped clients evade taxes through tax shelters and, ultimately, paying a $456 million penalty.\textsuperscript{71} PricewaterhouseCoopers also reached an agreement with the IRS in which it made a "substantial payment" in connection with tax shelter registration and list-maintenance problems.\textsuperscript{72} Ernst & Young has settled two cases. It settled a suit brought by the IRS for $15 million\textsuperscript{73} and another criminal matter with the Department of Justice for $123 million.\textsuperscript{74}

Settlement agreements also forced changes in business practices. KPMG had to disband certain high-risk practice groups while also agreeing to not develop or market any listed transactions.\textsuperscript{75} Ernst & Young also agreed that it would not plan, promote, or recommend any listed transaction or provide any tax services under conditions of confidentiality.\textsuperscript{76}

The government looked beyond accounting firms. The bulge bracket investment bank, Deutsche Bank, had to pay a hefty criminal penalty. It accepted a non-prosecution agreement from the Department of Justice in which it agreed to pay $554 million.\textsuperscript{77} In the agreement, Deutsche Bank conceded that it generated $29 billion in "bogus tax losses" that saved over 2,000 clients $6 billion in taxes.\textsuperscript{78}

The government has also asserted criminal charges against various individuals. For instance, it targeted thirteen KPMG partners\textsuperscript{79} along with lawyers at the now-defunct law firm of Jenkens & Gilchrist.\textsuperscript{80} Such individual criminal prosecutions, however, are not easy to secure. Most of the criminal charges against

\begin{itemize}
\item \textsuperscript{70} Korb, \textit{supra} note 19, at 322.
\item \textsuperscript{71} \textit{Id.} at 322-32.
\item \textsuperscript{72} \textit{Id.} at 321.
\item \textsuperscript{73} \textit{Id.}
\item \textsuperscript{75} Korb, \textit{supra} note 19, at 323.
\item \textsuperscript{76} Letter from Preet Bharara, U.S. Attorney, S. Dist. of N.Y., to Lawrence Pedowitz, Partner, Wachtell, Lipton, Rosen & Katz (Feb 26., 2013) (on file with author).
\item \textsuperscript{77} Barret, \textit{supra} note 54.
\item \textsuperscript{78} \textit{Id.}
\item \textsuperscript{79} United States v. Stein, 541 F.3d 130, 136-39 (2d Cir. 2008).
\end{itemize}
KPMG employees were dismissed due to constitutional concerns. The Jenkens & Gilchrist lawyers had their initial conviction thrown out. One Jenkens partner eventually pled guilty, but her co-defendants resisted, requiring a retrial.

Anecdotal evidence suggests that the government’s aggressive pursuit of criminal liability has had some positive effects. National firms have slowed down their tax shelter activity in the wake of the KPMG indictment. Perhaps more importantly, the terms of criminal settlement agreements forced some of the largest and most important accountancies to modify their business practices. It is unclear what sort of long-term impact the criminal investigations will have. Indeed, criminal indictments did not appear to slow down the activities of boutique advisory firms who thought that they were too small to be detected.

D. Assessing the Status Quo

Unfortunately, the AJCA did not put a conclusive stop to the tax shelter industry. The government has developed new tools to fight abusive corporate tax shelters over the last fifteen years. Many of these efforts have altered advisor incentives with penalties and other sorts of sticks. However, the abusive corporate tax shelter problem continues despite the advances of the AJCA and various landmark criminal settlements. Congress realizes that there still is a problem. As recently as 2010 it codified the Economic Substance Doctrine and imposed a forty percent strict-liability penalty on underpayments relating to a transaction that fails the doctrine’s two-prong test. Senator Carl Levin, who has led the charge against abusive tax shelters since 2002, has continued the fight by proposing the

81. The DOJ pressured KPMG to not advance legal fees to employees who did not cooperate in the criminal investigation. Stein, 541 F.3d at 136-39. This was found to violate the defendants’ substantive due process rights. Id. at 142.
85. Korb, supra note 19, at 1027.
86. Gleckman et al., supra note 84 (noting that these boutique firms “can fly under the IRS’s radar more easily”).
88. Id. § 6662(i) (West 2010); Rose, supra note 55, at 290.
89. See Rostain & Regan, supra note 17, at 1.
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Stop Tax Haven Abuse Act\(^9\) and the Cut Loopholes Act\(^9\) in 2011 and 2013, respectively. It is fair to question the sufficiency of the current legislative framework when it appears that one of its architects believes that there is still work that must be done. The reforms thus far—and even some of those still pending\(^9\) in Congress—are imperfect because they maintain a reactive enforcement structure.\(^9\)

This Section argues that the current legislative framework is imperfect and lays the foundation for explaining why creative solutions such as a special tax shelter patent are necessary. Specifically, there are two reasons to be skeptical that the government has won the war against abusive corporate tax shelters. First, the regulatory system adopted by recent reforms still leaves room for abusive activity. Second, widespread abusive corporate tax sheltering may emerge once the economy fully recovers from the financial crisis.

1. Problems with the New Legislative Framework

The greatest shortcoming of the new regulatory framework is that the IRS must still play a game of whack-a-mole when new abusive tax shelters emerge. Much like a player of whack-a-mole must reactively and repeatedly attack moles as they appear without end, the IRS detects the abuse only after it happens, and then it reacts: it pursues the taxpayer, assesses penalties if possible, and lists the transaction to force disclosure moving forward. The IRS is always one step behind. Its efforts are inherently reactive.\(^9\) Despite new penalties and disclosure requirements, sufficient incentives remain for creative tax advisors to dig new holes throughout the Code.

The IRS has tried to make its registration and list-maintenance requirements more robust, but these provisions do not anticipate novel tax shelters. There are five categories of transactions that trigger special disclosure requirements for taxpayers and their advisors: confidential transactions, transactions with contractual protections, listed transactions, transactions of interest, and loss transactions.\(^9\)


\(^9\) For instance, a provision of Senator Levin’s Stop Tax Haven Abuse Act continues to focus on increased penalties as the means for controlling advisor incentives. See Wilkins, supra note 56. Although increasing penalties might be justified, it continues the pattern of reform that has marked most of the efforts in the last decade without considering how to employ positive incentives.


\(^9\) 26 C.F.R. § 1.6011-4(b) (2010).
Tax advisors can evade the categories of confidential transactions and transactions with contractual protections simply by changing the way they manage their relationships with clients. Historically, tax shelter promoters have modified their contracting practices to evade similar regulations.96

Two other categories of listed transactions and transactions of interest are backward-looking. The IRS must first determine that a transaction is abusive before it will be placed on the official list.97 This approach is problematic since tax shelter engineers move onto a new device once their current products are discovered.98 The IRS then has to start all over. Incentives remain to continue developing new abusive schemes.99

The final category of loss transactions is perhaps the most promising because it is broad enough to capture novel tax shelters. It requires disclosure of all transactions claiming a large loss under section 165.100 This category may, however, cast too wide of a net requiring disclosure of legitimate losses.101 It might be difficult for the IRS to distinguish the good from the bad. Complex exceptions to the broad requirement may alleviate this concern. But the exceptions themselves could eventually provide creative promoters with new fodder for abuse.

Regardless of what category a tax shelter falls under, the potential revenue from promoting abusive tax shelters still outweighs the potential penalty exposure. There are four major penalties applicable to abusive tax shelter promoters103:

- Section 6700: A party who promotes an abusive tax shelter must generally pay a penalty equal to $1,000 or, if lesser, one hundred percent of the gross income from promoting the shelter.104

96. See, e.g., Novack & Saunders, supra note 22.
97. Korb, supra note 19, at 298.
98. See Rose, supra note 55, at 261.
100. 26 C.F.R. § 1.6011-4(b).
103. See INTERNAL REVENUE MANUAL pts. 20.1.6.2.1, 20.1.6.2.2 & 20.1.6.2.3, available at http://www.irs.gov/irm/part20/index.html. Although tax advisors can face other and additional penalties, these provisions are most applicable to an advisor who develops an abusive tax shelter without engaging in fraud.
104. 26 U.S.C. § 6700 (2006). In certain circumstances the penalty is fifty percent of gross income even if that is more than $1,000. Id.
**Section 6701:** Someone who aids or assists in a manner that they know will help a taxpayer understate their tax liability faces a penalty of $1,000 or $10,000.105

**Section 6707:** Failure to properly disclose a reportable transaction can result in a $50,000 fine.106 Such failure with respect to a listed transaction triggers a fine of $200,000 or, if more, fifty percent of income derived from activities relating to that transaction.107 Intentional nondisclosure increases the penalties to seventy-five percent of gross income.108

**Section 6708:** A promoter must make available a list of taxpayers they helped to use a device relating to a reportable transaction within twenty days of a written request or else they will face a daily penalty of $10,000 beginning on the twenty-first day.110

These penalties are imperfect. A tax promoter who devises a new shelter can evade the most significant penalties under sections 6707 and 6708.110 Although the penalties under sections 6700 and 6701 could apply to the most cutting-edge shelters, it is unlikely that fines of $1,000 or $10,000 will serve as a deterrent. A single new shelter idea can generate millions of dollars.112

Over the last few years, the sense of urgency surrounding abusive tax shelters has begun to fade.113 This may lead some to believe that the AJCA and other related reforms succeeded. But this would be a mistake. A new wave of abuse could

105. *Id.* at § 6701 (2006).
106. *Id.* at § 6707(b)(1).
107. *Id.* at § 6707(b)(2).
108. *Id.*
109. The list must include information about all the taxpayers for whom the promoter acted as a “material advisor.” *Id.* at § 6112(a).
110. *Id.* at § 6708(a)(1).
111. New abusive tax shelters would presumably not yet be listed transactions. As such, the hefty penalties for nondisclosure of listed transactions under section 6707(b)(2) would not apply. Indeed, it is possible that a $50,000 fine for reportable transactions under section 6707(b)(1) could be avoided with clever contracting and a watchful eye on the size of the loss generated. See Note, supra note 94, at 2270 (“Conventional wisdom suggests that increased penalties still leave tax shelters as lucrative options. To the extent that the disclosure provisions have bite only because of their liability consequences, the IRS will continue to find itself in the dark regarding the newest avoidance innovations.”).
112. Rostain & Regain, supra note 17, at 25.
113. For instance, the Stop Tax Haven Abuse Act failed to get out of a House committee in the 112th Congress and a re-introduced version of the bill continues to languish there as well. Stop Tax Haven Abuse Act, H.R. 2669, 112th Cong. (2011), available at http://www.govtrack.us/congress/bills/112/hr2669; Stop Tax Haven Abuse Act, H.R.
emerge again once the economy recovers from the financial crisis and memories of criminal prosecutions begin to fade.

2. A False Sense of Security

The three-year period from 2004 through 2006 was a turning point in the battle against abusive corporate tax shelters. Congress had recently passed the AJCA while the IRS was beginning to enjoy some appellate victories against taxpayers and the Justice Department’s criminal investigations against advisors had led to a couple of major settlements. Nevertheless, policymakers should not assume that the government has won the war. The right economic environment will allow abusive tax shelters to make a comeback.

The criminal indictment of KPMG marked a low point for the abusive tax shelter industry. Accountants and lawyers across the country were shocked that the firm helped facilitate the prosecution of individual partners. Some observed a discernible chill in abusive tax shelter advisory at elite firms. There is, however, good reason to believe that this deterrence will not last.

The circumstances surrounding the KPMG settlement were unique. First, KPMG’s wrongdoing came to light only after Hamersly, one of its rising stars, became a whistleblower. He testified before Congress and provided the government with incriminating evidence. Second, KPMG did more than simply design and market abusive shelters. The firm went so far as to encourage clients to file “misleading tax returns.” For instance, the firm advised clients using a certain shelter to use grantor trusts to obfuscate tax returns. Abusive tax shelters do not always have to rely on such outright deception. The KPMG case may have made headlines but it is unclear whether the

115. See Gleckman et al., supra note 84.
116. Hsue, supra note 37; Gleckman et al., supra note 84.
117. Rostain & Regan, supra note 17, at 1.
118. See Hearing Before the S. Comm. on Fin., supra note 29 (testimony of Michael Hamersly).
119. Rostain & Regan, supra note 17, at 24.
120. Id. at 25.
121. Id.
case should deter advisors who manipulate legal formalisms and encourage clients to engage in transactions lacking economic substance.

An optimist might point to the more recent settlements involving Deutsche Bank and Ernst & Young as evidence that the deterrent effects of these prosecutions will continue for some time. But these criminal cases all relate to activities that occurred in the early 2000s, around the time that KPMG's activities came to light. All these prosecutions were buoyed by the zeitgeist of that era. Over the last ten years, accounting firms and investment banks have been under intense public scrutiny. Indeed, Hamersly's decision to call the staff of Senator Levin was probably not random. Senator Levin presided over the hearings that exposed the financial abuses of Arthur Anderson in the Enron scandal. There will not always be political will to ferret out abuse. Indeed, in the late 1990s, the IRS was in congressional crosshairs for overzealous enforcement.

The risk that abusive tax shelters will reemerge is increased by the fact that there recently has been less attention paid to the tax shelter problem. The optimist might argue that this is because the problem has been resolved. But the inattention may be a result of the government not knowing how much abuse exists. It is very difficult to accurately measure the tax shelter problem. After all, many abuses are never detected and therefore cannot be perfectly measured. And some data can be misleading. For instance, in 1998 Kenneth Kies, then a co-managing partner of PricewaterhouseCoopers’s National Tax Service, argued that the abusive corporate tax shelter problem was a myth. To bolster his assertion, Kies cited a simple statistic: corporate income tax payments as a percentage of GDP were at their highest levels in recent decades. How could there be a corporate tax shelter problem with so much corporate tax revenue? The statistic is deceiving because it did not control for corporate profitability and could have just been a function of a healthy corporate sector in the strong economy of the late 1990s.


123. Rostain & Regan, supra note 17, at 1.

124. See GRAETZ, supra note 24, at 36-39.

125. See Rostain & Regan, supra note 17, at 4 (noting that “the government may never uncover all the tax shelters involved”).


127. Id.

This oversight is significant since federal corporate income tax revenue grew much more slowly than profits in the late 1990s, suggesting some sort of disconnect.\textsuperscript{129} Ultimately, a whistleblower, investigative journalists, and aggressive politicians demonstrated that abusive tax sheltering was rampant in 1998. In fact, Kies’s firm was at the center of the industry and ultimately paid a substantial fine to settle criminal charges.\textsuperscript{130}

It is possible that the abusive tax shelter industry has slowed down in the wake of the financial crisis. Large capital gains in need of artificial losses drive the demand for abusive tax shelters. The potential remains, however, for tax shelter promoters to provide a supply as the economy recovers. Various reforms over the last fifteen years have improved the government’s position. But there is still a need for new and creative solutions.

II. Encouraging Public Innovation Through Patents

There are two types of innovation in the tax context: private and public innovation. Private innovation encompasses taxpayers and their advisors who find creative ways around the law to minimize tax liabilities; public innovation involves the government improving laws and regulations to protect the tax base from abuse. While private innovators find loopholes, public innovators close them.

Investment in private and public innovation is not equal. Advisors have received hundreds of millions of dollars to find creative ways to manipulate the Code. Such fees encourage a large investment of human capital to find and exploit failures in the tax law. Underfunded public servants are left with the monumental task of detecting all these abuses, pursuing enforcement litigation, and amending laws and regulations.

One way to curb abusive corporate tax shelters is to level the playing field between private and public innovation. The government should enlist private actors to help detect and foreclose abuse. A variety of incentives can be used to achieve this objective. This Note describes the details of only a possible patent


\textsuperscript{130} Korb, \textit{supra} note 19, at 321 (describing the settlement of PricewaterhouseCoopers).
device, but it is important to acknowledge that other devices such as whistleblower incentives131 or prizes132 might achieve similar outcomes.

In this Part, I show how a special tax shelter patent program could supplement Congress’s and Treasury’s fight against abusive corporate tax shelters. The government has relied almost exclusively upon sticks to discourage the creation of abusive corporate tax shelters and to pressure tax advisors to disclose information. There is a problem with this reactive enforcement model: at best, the government undergoes tremendous expense and delay in detecting the newest schemes and, at worst, a scheme goes undetected.

Positive incentives would close the gap in the government’s strategy. Properly structured patent protection could facilitate proactive enforcement. Patents could harness the energy and resources of the private tax bar to help Congress and the Treasury identify abusive shelters and improve the law. Private actors would have an incentive to facilitate public innovation.

Congress should create a special patent device that encourages tax shelter engineers to move away from their traditional attachment to secrecy. The special patent would still grant a monopoly—limiting the number of taxpayers who can use a shelter—but it would encourage more disclosure through an immunity device.

The voluntary disclosure of tax shelter methods would improve public innovation. The information would have numerous uses. Congress can use it to

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131. The IRS already has a Whistleblower Office that promises those who provide specific information about an underpayment of taxes up to thirty percent of the taxes and penalties collected. Whistleblower—Informant Award, INTERNAL REVENUE SERV., http://www.irs.gov/uac/Whistleblower-Informant-Award (last visited Dec. 7, 2013). But the program is only as good as the IRS’s apparently limited ability to prosecute those claims. Since the program began in 2006, the IRS has paid out very few rewards. Erika Kelton, IRS Whistleblowers See Little Reward, FORBES (Mar. 2, 2012, 9:57 AM), http://www.forbes.com/sites/erikakelton/2012/03/02/irs-whistleblowers-see-little-reward/. And the government even rewarded one of these whistleblowers with prison time—likely deterring others from coming forward. See James O'Toole, $125 Million Paid to IRS Whistleblowers, CNNMONEY (Feb. 13, 2013, 6:12 PM), http://money.cnn.com/2013/02/13/news/economy/irs-whistleblowers/index.html. All this suggests that the existing program is of limited utility. The Whistleblower Office might benefit from considering some of the suggestions in this Note that are meant to motivate disclosure—such as immunity discussed below. See infra Part II.B.ii.a.

132. There is an extensive literature on the comparative merits of prizes and patents. This Note’s focus on patents is not intended to comment on the relative strengths of these two devices. Both prizes and patents share a characteristic sorely missing in the current enforcement strategy of the IRS: influencing behavior through positive incentives. It is possible that some of the benefits of the special tax shelter patent could be achieved through a prize. For instance, the IRS could provide cash prizes to those who discover and disclose flaws in the Code that facilitate tax shelters. But this paper leaves the details of such a device—and the comparative benefits thereof—for future scholarship.
amend the tax laws; Treasury Department policymakers can use it to update regulations and listing requirements; and the IRS could use it to audit corporate tax returns more effectively. The tax shelter patent could create a mutually beneficial bargain between the regulated and the regulators.

Recently, patents and tax law have not mixed well. The tax strategy patents that proliferated between 2003 and 2011 failed to effectively encourage disclosure of creative tax shelter ideas. Although policymakers recognized the potential of tax strategy patents to facilitate some disclosure, they did not carefully consider how to more effectively encourage disclosure. Instead, they banned such patents in the America Invents Act. This decision was a mistake because policymakers failed to appreciate the untapped potential of patents in the tax context.

Specifically, tax shelter patents should incorporate the following three special features to maximize productive disclosure at minimal cost to the tax base:

- A patentee should have a limited and defined immunity to use or license their patented tax shelter. Without immunity, tax shelter engineers would reasonably fear sharing their idea with the government. The immunity could be designed to require patentees to specify amendments to laws and regulations that would foreclose their abusive tax shelter.

- Tax shelter patents should be administered in a special office in the Treasury Department. Locating patent review in the Treasury will also ensure that information gleaned from applications will be seamlessly transferred to the relevant policymakers.

- All natural persons (and their advisors) who earn below a certain threshold of income should be exempted from tax shelter patent liability. This limitation will ensure that tax shelter patents focus on the narrow problem of abusive corporate tax shelters.

It is unusual to create a special patent regime for particular fields. However, the unique purpose of tax shelter patents—to generate public innovation—requires these special provisions.

This Part is divided into two Sections. First, it presents the history of patents in the tax context and the controversy they generated. Second, it describes the potential for a special tax shelter patent to help the government in its battle against abusive corporate tax shelters.

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133. See THOMAS, supra note 14, at 15.

134. JOINT COMM. ON TAXATION, supra note 13, at 24 (noting that granting a patent does not generally provide immunity).

135. See Drennan, Should the Empire Strike Back?, supra note 13, at 495.
A. History of Tax Strategy Patents

In 2011 Congress passed one of the most sweeping patent reform laws in decades: the Leahy-Smith America Invents Act ("AIA"). The law quietly ended a debate between tax practitioners and intellectual property experts regarding a new breed of patents on tax strategies. Such patents were a sub-genre of business method patents that gave a patentee the exclusive right to use and license the use of a strategy to reduce tax liability.

Tax strategy patents were controversial. Tax scholars argued that such patents were inappropriate given the special context of tax law, while intellectual property experts responded that innovation in tax practice is no different than innovation in other fields. The AIA sided with the tax bar. This Section reviews this debate and concludes with an observation about it: neither critics nor proponents of tax strategy patents fully considered how to unlock the potential disclosure benefits of tax shelter patents. This Section will identify this gap in the debate and suggest that policymakers erred by viewing the tax strategy patent as a yes or no proposition. Rather than pursue a complete ban, policymakers should have fashioned a special regime that unlocks the potential disclosure benefits of patents in the tax context. The proposed special tax shelter patent can do just that.


137. THOMAS, supra note 13, at 6.

138. Id. at i.

139. See Hearing on Issues Relating to the Patenting of Tax Advice, supra note 13; JOINT COMM. ON TAXATION, supra note 13, at 25; THOMAS, supra note 13, at 12-14; Closson, supra note 13, at 167-70; Should the Empire Strike Back?, supra note 13, at 492-93; Drennan, The Patented Loophole, supra note 13, at 280; Drennan.

140. THOMAS, supra note 13, at 16; Christopher C. Anderson, Patents on Tax Strategies: Just Another Harmless Subject, 2009 U. ILL. L. REV. 1591, 1611-12 (2009); Stephen T. Schreiner & George Y. Wang, Discussions on Tax Patents Have Lost Focus, LAW360 (July 21, 2006, 12:00 AM), http://www.law360.com/articles/7648/discussions-on-tax-patents-have-lost-focus.

141. Certain commentators did discuss the disclosure benefits relating to tax strategy patents. See, e.g., Anderson, supra note 140, at 1609-10; Lucas Osborn, Tax Strategy Patents: Why the Tax Community Should Not Exclude the Patent System, 18 ALB. L.J. SCI. & TECH. 325, 359-60 (2008). But these authors failed to appreciate that immunity and other more radical modifications to the traditional patent paradigm are necessary in the tax context to unlock these potential disclosure benefits. See infra Part II.A.ii.
1. What Constituted a Tax Strategy Patent?

Tax strategy patents were made possible by the Federal Circuit decision in *State Street Bank & Trust Co. v. Signature Financial Group* which laid to rest the business method exception to patentability. The PTO issued 161 tax strategy patents between 2003, when it issued the first such patent, and 2011, when the AIA ban went into effect.

At a high level of abstraction, tax strategy patents involve “methods that individuals and enterprises might use in order to minimize tax obligations.” The PTO used the phrase “tax strategy patent” loosely, so it is helpful to examine the actual patents issued by the PTO. One survey of all the so-called tax strategy patents issued between 2003 and 2007 categorized the patents into one of seven groups: patent does not mention taxes; patent involves a method where taxes are of secondary importance; patent involves a computer program designed to compute tax liability; patent involves a computer program to facilitate tax-efficient portfolio management; taxes are critical to the patent; patent involves a strategy utilizing life insurance products to reduce taxes; and patent involves a process or strategy designed specifically to reduce tax liability. The final category has garnered the most attention. These patents involved “a financial structure or product used in a strategy or process to reduce taxes and . . . claims with respect to the underlying tax strategies.” By 2007, the PTO had issued only five such patents.

Perhaps the most high profile was the Wealth Transfer Group’s SOGRAT patent (no. 6,567,790). It claimed an estate planning strategy for minimizing gift tax liability relating to the transfer of nonqualified stock options among family members. It uses a Grantor Retained Annuity Trust (GRAT) funded with nonqualified stock options. This device obtains a tax advantage by separating the appreciation of the stock options from the grantor’s estate.

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145. THOMAS, *supra* note 13, at i.


147. Chumney et al., *supra* note 146, at 343.

148. *Id.* at 360.

149. *Id.* at 358.

150. THOMAS, *supra* note 13, at 11.

151. *Id.*
Enforcement of the SOGRAT patent sent shockwaves among tax practitioners. Wealth Transfer Group learned that an executive at Aetna had funded two GRATs with nonqualified stock options. In 2006, Wealth Transfer Group brought one of the first tax strategy patent enforcement actions ever against the executive. Just one year later, the suit ended in a settlement whereby both parties stipulated that the patent was "valid and enforceable." Many were disturbed by the SOGRAT patent because GRATs were a common tool used to manage gift tax liability. Tax practitioners were terrified that such common tax saving strategies could be patented and enforced, and this outrage led them to lobby against tax strategy patents. The SOGRAT patent set the terms of the debate surrounding tax strategy patents.

2. The Controversy Surrounding Tax Strategy Patents

This Subsection evaluates the arguments made by both the proponents and opponents of tax strategy patents. It concludes that neither side fully appreciated how to effectively take advantage of the disclosure benefits of such patents, which suggests that there is good reason to now reconsider the complete ban.

One popular criticism of tax strategy patents was that the features of the tax law that enable tax-minimization are a public good that should be open to all taxpayers. These commentators argued that it is unfair for the government to force citizens to pay taxes but to restrict their ability to use the most efficient transaction structure possible. Intellectual property experts who knew the full breadth of patent law responded that this concern is not unique to tax law. For instance, a strategy that reduces tax costs is conceptually no different than an improved catalytic converter that minimizes regulatory costs stemming from emission requirements.

152. Osborn, supra note 141, at 348-49.
154. THOMAS, supra note 13, at 11-12.
155. Monks, supra note 153, at 933.
156. Chumney et al., supra note 146, at 358.
157. Moulton, supra note 13, at 632.
160. Schreiner & Wang, supra note 140.
161. Id.
Another popular criticism of tax strategy patents focused on the PTO. Some argued that the PTO was unable to effectively administer tax strategy patents because examiners lack the necessary tax expertise. One high-profile mistake was the PTO's decision to issue the SOGRAT patent. This patent was a mistake not because all tax patents inherently are unviable, however, but rather because it is weak in regards to two critical requirements for a valid patent. The preexisting, widespread use of GRATs suggests that the patent was neither novel nor non-obvious. Additionally, the tax community may have misread the capitulation of the Aetna executive. The court's decree that the SOGRAT patent was "valid and enforceable" was binding on only the two parties pursuant to the terms of their settlement. Some have tried to predict the validity of the patent based on the settlement but it might have just been the byproduct of a conservative litigation strategy.

The SOGRAT patent did raise valid concerns about the PTO's capacity to effectively administer tax strategy patents. But, even if the PTO mismanaged some applications, that should not condemn an entire class of patents. The natural solution would be to focus on improving the administration of such patents, as this Note's proposal does.

Two of the most significant criticisms of tax strategy patents concerned incentives. One of the major policy justifications for patents is that they motivate innovation. Some critics argued that the government should not incentivize the proliferation of tax-minimization strategies because they harm the tax base. Other critics took the exact opposite approach. They argued that there already was a strong enough incentive to minimize taxes so patents are superfluous.

Juxtaposing these two arguments reveals a contradiction. The notion that patents are not necessary to motivate tax innovation cuts against the argument that patents harm the tax base. But, perhaps more troublingly, this utilitarian calculus focuses too narrowly only on the incentives of tax professionals to produce more tax strategies—private innovation. Neither side of the debate paid sufficient attention to the role that patents can play in spurring public innovation.
KEEPING YOUR ENEMIES CLOSER

Patents can play a role in spurring public innovation by encouraging private actors to help the government in its quest to detect and respond to manipulations of the Code. For the most part, commentators did not fully appreciate the potential for tax patents to spur public innovation in the tax law itself. But some who were familiar with a patent’s disclosure requirements did notice this possibility. Nevertheless, even these scholars did not appreciate the need for a radically unique tax shelter patent to fully unlock this potential.

Those who observed the disclosure benefits of tax strategy patents did not go far enough in their proposals. One commentator, Lucas Osborn, merely suggested requiring mandatory publication of tax strategy patent applications within eighteen months—a common feature of patent law outside the United States for which some Americans have advocated domestically. Given the level of sheltering that can occur in a short amount of time, it is unclear whether that time-line is helpful. Even if it were helpful, mere publication alone without immunity does little to encourage secretive tax shelter promoters to come out of the shadows.

Another author, Christopher Anderson, astutely recognized that there was a disincentive against filing a tax strategy patent that seizes upon a questionable loophole. But his proposal for improving disclosure overlooked this concern and merely suggested that all applications for a tax strategy patent “disclose the loophole” which is the basis for the tax strategy. Indeed, such a requirement in isolation without immunity would only strengthen the disincentive for filing a tax strategy patent. Anderson argued that competitive dynamics alone would encourage such advisors to nevertheless file for a patent. But this intuition that there will be a race to file a patent—common in the intellectual property literature—overlooks the reality in the abusive corporate tax shelter industry: secrecy is the industry’s motto. There is unlikely to be any race if all those who could sprint to the PTO’s doorstep are warier of the government than one another. And empirical evidence demonstrates that abusive tax shelter engineers never filed a single tax strategy patent. Even the defenders of tax strategy patents did not appreciate the need for a truly unique patent device to unlock the benefits of disclosure. Instead, they locked horns with critics and engaged in an all-or-nothing debate: either there should be no tax strategy patents or tax strategy patents should be treated much like every other genre of intellectual property.

169. Anderson, supra note 140, at 1609-10; Drennan, The Patented Loophole, supra note 13, at 328; Osborn, supra note 141.
170. Osborn, supra note 141, at 359-60.
171. See infra Part II.B.i.a.
172. Anderson, supra note 140.
173. Id. at 1610.
174. Id.
175. Moulton, supra note 13, at 638-39.
Ultimately, the critics prevailed with the passage of the AIA. Opponents of tax strategy patents enjoyed a resounding victory as the AIA established that by definition a tax strategy patent was not novel. But Congress also failed to fully consider the potential benefits of a special tax shelter patent regime that could generate true disclosure of abusive tax shelters. This oversight suggests a need to reconsider the complete ban as soon as possible before inertia creates a bias in favor of the status quo.


Advisors have been finding creative—and sometimes abusive—ways to manipulate the Code throughout the history of the modern income tax. The government has generally responded by employing deterrent tactics ranging from penalties to criminal prosecution.

But there are two ways to manage incentives: carrots and sticks. In the fight against abusive corporate tax shelters, the government has almost exclusively relied on sticks. The government should supplement these sticks with the carrot of tax shelter patents designed to encourage promoters to share information about their products with the government. Congress and the Treasury Department can use this information to close the loopholes. In exchange, the promoter who comes forward with useful information can be rewarded with a monopoly on the strategy and limited immunity to use or license the use of the tax shelter.

At first glance, this approach is counterintuitive. After all, abusive tax shelter promoters are the “bad guys.” It is unseemly to reward them. But the patent is a quid pro quo whereby the government purchases information that will help it proactively confront tax shelter abuse. In an ideal world such a bargain would not be necessary—but we do not live in an ideal world.

This Section first describes how tax shelter patents can help policymakers and regulators combat abusive tax shelters. It then discusses certain ways in which the tax shelter patent will need to differ from traditional patents in order to achieve its full potential.

1. The Hidden Potential to Revolutionize the Fight Against Abusive Tax Shelters

Unlike traditional patents, a special tax shelter patent would motivate the development of public laws and regulations. In order to understand the way tax shelter patents will improve the government’s ability to handle the problem of abusive corporate tax shelters, it is important to appreciate the way in which the government currently handles new tax shelters as they emerge. To that end, this Subsection first describes the normal pattern by which the government detects a

problem in tax law and responds to it. It then explains how tax shelter patents can spur quicker innovation in tax law.

a. Evaluating the Current Pattern

The development of an abusive corporate tax shelter follows a predictable lifecycle. First, the government creates a law or regulation to achieve a certain objective while trying to draft the statute to avoid unintended loopholes. Second, once the law or regulation is promulgated, a sophisticated industry takes a look at it to see if there is a way to take advantage of it. Some tax advantages are intended by Congress. But sometimes, tax shelter engineers observe a loophole through which they can manufacture an abusive transaction. Third, tax shelter engineers perfect their product and market it to their consumers: taxpayers. Eventually (though not inevitably) the government learns about the shelter. If possible, the IRS moves to collect taxes and penalties. And, more importantly, policymakers change laws and regulations to close that particular loophole.177

ACM Partnership demonstrates that it is very difficult for a small staff of public servants to predict how armies of well-financed tax professionals will manipulate formalisms. That tax shelter was premised on ratable cost recovery rules relating to contingent installment sales.178 Ratable cost recovery rules responded to transactions where a taxpayer sells property in exchange for future installment payments that are contingent on future events.179 Because future income is uncertain, it is not perfectly clear how to apportion the seller’s cost over time. The Supreme Court in Burnett v. Logan took the position most favorable to the taxpayer: the seller could recover their entire cost before reporting any gain from the sale.180 But under certain circumstances this rule created deductible tax losses in the absence of economic losses.

Eventually, Congress authorized Treasury to stop the accelerated cost recovery sanctioned by Burnett.181 Treasury regulations established that when the payment period is fixed but the amount is uncertain, cost should be allocated in equal amounts over the payment period.182 But regulators knew that creative practitioners could manipulate such a formalistic rule.183 So they created a regulation that allowed the Treasury to require that a taxpayer use a different basis

177. Yin, supra note 58, at 216.
180. Id. at 1943 (citing Burnett v. Logan, 283 U.S. 404, 413 (1931)).
181. Id. at 1943.
182. Id. (citation omitted).
recovery method if application of the ratable recovery rule would “substantially and inappropriately accelerate recovery of basis.”

This valiant attempt to proactively stop abusive tax sheltering failed to prevent the scheme in ACM Partnership. Merrill Lynch advised Colgate to defer—not accelerate—basis recovery.

When the government detects abuses such as this, it will enact specific changes to the applicable laws or regulations. The following list includes several examples of congressional or administrative responses to an abusive tax shelter:

- An amendment to section 357(c) of the Code eliminated “basis creation” in certain abusive transactions.
- Two statutes stopped abuse of corporate-owned life-insurance plans.
- An IRS ruling letter curbed a tax shelter based on lease-in, lease-out transactions.
- Congress prevented financial institutions from avoiding corporate taxes through the use of liquidating REITs.

Congress and the Treasury have acted quickly to close such loopholes when the IRS has detected them. But there is no guarantee that the IRS will ever detect a tax shelter.

The reactive nature of this pattern is problematic for three reasons. First, it is expensive and difficult for the government to detect a new abusive tax shelter. The IRS has limited resources with which to stop an abusive tax shelter. A small minority of tax returns are audited. And even when there is an audit, it can take years to complete. Success comes at a cost—the litigation in ACM Partnership, for example, cost $2 million.

Second, abusive corporate tax shelters can cause a lot of harm in a short period of time, increasing the cost of the government’s slow response. For instance,

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184. Id. (emphasis added) (citation omitted).
185. Id.
187. Id. at 4-5.
188. Id. at 4 (citations omitted).
189. Id. (citation omitted).
190. Id.
191. Id. at iv-v.
192. Rostain, supra note 4, at 87.
193. DEP’T OF TREASURY, supra note 186, at v.
one investment bank generated $8 billion of investments from a certain tax shelter during a few short months. Over several years, the financial toll can be astronomical. For instance, between 1995 and 1997, the value of mortgages in a certain type of REIT related to a particular type of tax shelter increased from $9 billion to $111 billion. This shelter reduced tax receipts by at least $500 million in 1997 alone.

Third, the government’s legislative and administrative response is often not retroactive. Black & Decker Corp. v. United States illustrates this blind spot. The Fourth Circuit reviewed a transaction in which the taxpayer managed to engineer an economically nonexistent $560 million loss that it used to offset a capital gain. The Court ruled in favor of Black & Decker based on the plain meaning of a certain Code provision governing the basis of a taxpayer who transfers property to a controlled corporation in exchange for stock. Congress did not intend this result and responded to Black & Decker with the Community Renewal Tax Relief Act of 2000. But the law was not retroactive and it did not apply to Black & Decker who had used this shelter in 1998.

The government has attempted to improve its position with penalties and other sticks. But this approach still requires the IRS to detect the use of an abusive tax shelter before it can exact penalties or shut it down. It is not always clear that the IRS will always have the resources or political will to actively police abusive corporate tax shelters.

b. The Role of Tax Shelter Patents

Tax shelter patents will realign advisor incentives. Now when someone discovers a tax shelter they rush to the taxpayer market. A tax shelter patent will encourage promoters to rush to the government instead.

The monopoly afforded by a patent is financially valuable to the patentee. A patentee has the exclusive right to use or license the use of an innovation. Patentees may enforce this right by seeking injunctions, lost profits, reasonable royalties, and enhanced damages in the case of willful infringement. These powerful legal rights enable a monopolist to enjoy supernormal returns because they can charge a premium over prices in a competitive market.

194. Id. at iii.
195. Id. at 31.
196. 436 F.3d 431 (4th Cir. 2006).
197. Id. at 434.
198. Id. at 436.
199. Id. at 434.
200. Id.
Traditional tax strategy patents did not attract those who design sophisticated and aggressive tax shelters. This is not surprising since confidentiality has historically been the industry’s creed. But it is possible to encourage abusive tax shelter promoters to come out of the shadows with limited immunity. If promoters do not fear divulging information to the government, competitive dynamics will encourage a race to file for a patent. Tax shelter engineers fear the competition because gossip and reverse engineering are rampant. Competition is all the more worrisome since Treasury regulations make it difficult for advisors to maintain trade secrets. Traditional tax strategy patents were not very successful because this fear of competition was overshadowed by a stronger terror of the government—but immunity would change that.

It is also important to observe that a tax shelter idea has the traditional qualities of patentable intellectual property. Economic theory suggests that a monopoly right is appropriate to protect expensive research and development that generates an idea that is neither rivalrous nor excludable. Tax shelter innovation fits this description. The development cost of a tax shelter can reach a million dollars, but the marginal cost of selling the tax shelter to additional clients is relatively insignificant. Second-movers who merely copy a shelter developed by others will have a competitive cost advantage.

Awarding a patent to a tax shelter engineer—especially someone who comes up with an abusive idea—seems problematic. After all, these ideas damage the tax base. But, as critics of tax strategy patents point out, there is already a very strong incentive to minimize taxes in the absence of the patent right. In this sense, tax shelter ideas are distinguishable from the other sorts of intellectual property.

But a special tax shelter patent does create an incentive for advisors to disclose their research to the government. This in turn spurs public innovation. The House Ways and Means Committee has stated that “the best way to combat tax

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202. See Moulton, supra note 13.

203. Confidentiality is so important to abusive corporate tax shelters that the Treasury Department considers the execution of a confidentiality agreement during tax advisory work as a possible indicator of abuse. See 26 C.F.R. § 1.6011-4(b) (2010).

204. Novack & Saunders, supra note 22.


206. See generally Chumney et al., supra note 146 (describing the lackluster quality of tax strategy patents).

207. Hsue, supra note 37, at 943 n.35.

208. Id. at 910.

209. See THOMAS, supra note 13, at 12; Moulton, supra note 13, at 656-57.
shelters is to be aware of them.”210 There are many ways that the government can use the information disclosed in a tax shelter patent application.211 For instance, the government can update tax shelter disclosure and listing requirements, audit tax returns with better information about the indicators of abuse, and amend the laws and regulations to close loopholes. The government already takes many of these actions but the tax shelter patent would create a more efficient, proactive paradigm. The IRS would no longer have to blindly scour tax returns to find some hint of abuse. Instead, a tax shelter promoter would be motivated to willingly come forward. This will reduce the cost of tax shelter investigations and enforcement.

The tax shelter patent would be unique in certain respects. The utilitarian calculus undergirding patent law recognizes a tradeoff between increasing the incentive to innovate and creating a monopoly. Monopolies generate deadweight loss because monopolists sell less of a good at higher prices than they otherwise would in a competitive market. But, in the unusual case of abusive corporate tax shelters, this deadweight loss is associated with a positive externality: fewer tax shelters translate into more tax revenue.

Patent enforcement will also supplement tax enforcement to reduce the volume of sheltering. The patentee will be an ally for the government since they would both want to reduce the proliferation of particular tax shelters. A patentee will have an incentive to investigate whether its competitors are using a particular strategy and its investment in mining industry gossip or securities disclosures will help the IRS.

The unique features of the tax shelter patent suggest that it will be sui generis. The unusual nature of the bargain it represents between the public and private sector indicates that it should not be treated like other forms of intellectual property. This justifies overlooking the impulse of intellectual property experts to maintain a unitary system for all utility patents.213 While most principles of patent law are applicable, certain modifications are necessary to ensure that tax shelter patents meet their full potential.

2. Special Features of a Tax Shelter Patent Regime

Many traditional patent law doctrines governing threshold requirements, defenses, or remedies are applicable in the tax shelter context. But the failed experiment of tax strategy patents demonstrates the need for special accommoda-

211. JOINT COMM. ON TAXATION, supra note 13, at 23-24.
212. Monks, supra note 153, at 908-09 (describing a tax patent-holder’s infringement lawsuit).
213. See Drennan, Should the Empire Strike Back?, supra note 13, at 495.
tions in the tax shelter context. The tax strategy patents issued by the PTO generated more debate than actual, valid patents.\textsuperscript{214} Perhaps most importantly, the recalcitrance of abusive tax shelter engineers to divulge their secrets in patents suggests that the traditional framework had limited disclosure benefits.\textsuperscript{215}

Not a single tax strategy patent involved an abusive strategy. The IRS reviewed all 6.5 million patents in the PTO’s database and concluded that none of them involved a listed transaction.\textsuperscript{216} It is not surprising that abusive tax shelter promoters did not attempt to patent any of their products. The disclosure requirements of the patent laws are a serious disincentive.\textsuperscript{217} But the fact that tax strategy patents did not yield meaningful disclosure does not mean that it would be impossible to encourage tax shelter engineers to cooperate through patents.

This Subsection describes three focused provisions that should be included in any legislation to create a tax shelter patent in order to ensure that tax shelter patents will achieve their purpose.

\textit{a. Limited Immunity}

It is not easy to encourage tax shelter promoters to disclose their proprietary research publicly—let alone directly to the government. Indeed, some well-intentioned proponents of traditional tax strategy patents likely failed to appreciate this fact.\textsuperscript{218} This barrier is illustrated by the fact that there was not a single listed transaction patented amongst the PTO’s database of 6.5 million patents.\textsuperscript{219} But limited immunity may facilitate a voluntary transfer of information and is, as such, perhaps the most important feature of the proposed special patent.

The immunity would provide a patentee with two forms of protection. First, a particular change in laws or regulations that closes a loophole necessary for the tax shelter will not apply to the patentee if (i) their patent application specifically disclosed that that change in law or regulation would close a loophole that facilitates their shelter and (ii) the patent application materially contributed to that change in laws or regulations. Simply put, this would freeze the law for the patentee if they help policymakers identify shortcomings in the current law.

Second, the IRS cannot pursue the patentee or their licensees through the economic substance doctrine. The economic substance doctrine attacks tax positions that are formally plausible but economically questionable—a common

\begin{figure}[h]
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\includegraphics[width=\textwidth]{figure.png}
\caption{Figure 1: Visualization of the discussed concepts.}
\end{figure}

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\caption{Table 1: Example data presentation.}
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\textsuperscript{214} Closson, \textit{supra} note 13, at 173.
\textsuperscript{215} Moulton, \textit{supra} note 13, at 638-39.
\textsuperscript{216} \textit{Id.}
\textsuperscript{217} \textit{See} 35 U.S.C. § 112; Anderson, \textit{supra} note 140, at 1610; \textit{see also} Moulton, \textit{supra} note 13, at 639.
\textsuperscript{218} \textit{See}, e.g., Anderson, \textit{supra} note 140; Osborn, \textit{supra} note 141.
\textsuperscript{219} Moulton, \textit{supra} note 13, at 638-39.
characteristic of certain abusive tax shelters. The IRS would still be able to punish patentees who violate the letter of the law or commit outright fraud. But this immunity alone would provide a patentee an incentive to disclose even if their proposed change in law is not adopted by Congress or the Treasury.

These two immunities would incentivize disclosure of tax shelter ideas and resolve the Arrow’s Paradox that surrounds this informational transaction. And the immunity eliminates the concerns that discourage a tax shelter engineer from transparently sharing their ideas with the government. Patentees would not have to worry about being punished for disclosing their secrets. Such trust is a necessary ingredient for mutually beneficial cooperation. In order to facilitate a proactive, cooperative approach, the IRS needs to kindle such confidence. As it stands, the IRS’s history of punishing even whistleblowers is a hurdle that the Treasury must overcome and such a bold regime of systematic immunity will facilitate that.

Moreover, the immunity will encourage more robust disclosure than would otherwise be required under traditional patent law. The patentee will make the task of the Treasury Department and Congress easier since the application will suggest specific ways that current laws and regulations can be improved. And since the scope of immunity is tied to the quality of the change-of-law disclosure, the patentee and the government will have congruent incentives.

A tax shelter patent combined with limited immunity could have influenced the incentives of Merrill Lynch—the advisor who marketed the tax shelter in ACM Partnership. Merrill Lynch marketed a tax shelter that preyed upon gaps


221. Arrow’s Paradox refers to “the general problem with selling information: To sell, one must disclose the information, but once the information is disclosed, the recipient has the [information] and need not buy it. On the other hand, if one does not disclose anything the buyer has no idea what is for sale.” Robert Merges, Intellectual Property Rights and Bargaining Breakdown: The Case of Blocking Patents, 62 TENN. L. REV. 75, 81 (1994). In the context of the tax shelter patent, there is a comparable informational exchange between the government and the patentee. The government is giving a patent and, in exchange, they are receiving information that can help improve the law.

222. See, e.g., O’Toole, supra note 131 (noting that “[t]he IRS has been authorized to pay rewards to whistleblowers since 1867” and that it had “issued 128 whistleblower rewards for the 2012 fiscal year”).

223. Patent law only requires that the patent application enable the public to practice the method or strategy. 35 U.S.C. § 112 (2006).

224. ACM P’ship, 157 F.3d at 233.
in section 453 of the Code and related regulations concerning contingent installment sales.\textsuperscript{225} In particular, Merrill Lynch found that it could attain a tax advantage for its clients by deferring basis recovery\textsuperscript{226}—an unforeseen abuse since policymakers only considered abuses that accelerate basis recovery.

Merrill Lynch rushed to taxpayers like Colgate to seize upon the loophole. The patent and immunity would have encouraged Merrill Lynch to come to the government first. Merrill Lynch’s patent application could have suggested that the Treasury foreclose such tax shelters by amending Treasury Regulation § 15a.453-1 to give the IRS authority to impose alternate forms of basis recovery in situations of substantial and inappropriate deferral in the context of contingent sales. The IRS would have been put on notice sooner that there were significant loopholes in section 453 and its related regulations. This knowledge would have allowed it to audit corporate tax returns more effectively. The information could also allow the IRS to classify such deals as a listed transaction thereby triggering related listing and disclosure requirements. Finally, the IRS could amend regulations in the manner suggested in the application. The Treasury would have to “pay” for this information by granting Merrill Lynch a patent and immunity.

At first glance, such immunity may seem inappropriate. It would appear as though the government is compensating Merrill Lynch for an idea that damages the tax base. But it is important to observe that significant abusive tax sheltering already happens in the shadows. Policymakers are not operating in an ideal world—they must understand the choice they are facing. They are not choosing between no abuses and immunizing some abuse. The choice is between continuing to play a reactive game of whack-a-mole with sophisticated advisors and obtaining their cooperation to create a proactive paradigm. The tax shelter patent and immunity is the price of information.

The immunity could also be coupled with the following creative devices to reduce the government’s financial exposure: duration limits and monetary caps on the immunity. Duration limits could establish that the immunity will be shorter than the patent right itself, thereby limiting the time period in which the patentee can legally use a potentially abusive tax shelter. The primary comparative advantage of duration limits is that they would be relatively easy to administer. Monetary caps would be more complex, but would more precisely limit the government’s financial exposure, which could be significant given the capacity of large institutions to serve many clients in a short amount of time.

There are two possible types of monetary caps. Immunity could expire once the patentee enjoys a certain threshold amount of fees or tax benefits. Alternatively, the immunity could expire once the patented method shelters a certain amount of tax liability. The cap on sheltering levels might be harder to administer.

\textsuperscript{225} Id. at 234.

\textsuperscript{226} Smith, supra note 183, at 28-29.
since it would require collecting information from the patentee about their activities. But it would allow the government to place a firm limit on a particular tax shelter’s impact on the tax base.

The exact level of the monetary cap or duration of the temporal limit would have to balance the patentee’s development costs and reasonable profit expectations with the needs of the Treasury. Great care would have to be taken in setting these levels. Policymakers must remain pragmatic and avoid the easy impulse to set a miserly limit that looks good on a budget spreadsheet but, in effect, undermines the entire patent device by discouraging cooperation. In this scenario, the special tax shelter patent might fail to encourage disclosure much like the traditional tax strategy patents. At the same time, an overly generous monetary cap or durational limit could leave the tax base exposed and effectively give abusive tax shelter promoters a free pass. Indeed, to navigate between Scylla and Charybdis, legislators will need to be flexible and ready for a potentially iterative process that involves some experimentation.

Finally, it is important to note that such immunity regimes are not unprecedented. It is analogous to the use of immunity in gun buyback programs and criminal prosecution. In recent decades, gun buyback programs have become popular at the federal, state, and local level. For instance, in one such program in New York, a local government offered people cash in exchange for their weapons in order to reduce the supply of guns in the community. The cash offer was combined with a promise of immunity if there was evidence that a gun law was violated. These programs have successfully encouraged people to surrender their weapons thereby reducing the risk that the weapons would be used to kill or maim. In one gun buyback program in Camden, New Jersey, residents turned over 1,100 guns while in another the Los Angeles Police Department collected thousands of weapons including two rocket launchers. Beyond gun buyback programs, immunity is more generally available in the criminal justice system. Prosecutors have general discretion to enter into immunity agreements with defendants.

227. See Moulton, supra note 13, at 638–39.
228. See Anthony Braga et al., The Illegal Supply of Firearms, 29 CRIME & JUST. 319, 345 (2002).
230. Id.
231. Id.
232. Id.
234. Id. at 111.
Immunity in both of these contexts is controversial. Retributivist theory suggests that it is unjust to excuse punishment in this manner. But in both of these contexts, immunity is seen to serve some utilitarian purpose. In the gun buyback context, it encourages people with secret, illegal weapons come forward. A prosecutor's immunity offer often provides the government with information that they would otherwise not have. Limited tax shelter immunity similarly allows the government to obtain information that will allow it to efficiently update and enforce the tax code.

b. Administration by the IRS

The PTO currently administers all patent applications across diverse fields. Although the PTO effectively manages applications involving all these diverse technologies, its handling of tax strategy patents suggests that it might not effectively administer tax shelter patents. An office within the Treasury Department would bring more expertise to bear on tax shelter patent applications. And, more importantly, it would further the purpose of tax shelter patents: efficient development of tax laws and enforcement.

One of the popular criticisms of tax strategy patents was that the PTO was ill equipped to handle tax law. For the most part, the PTO hires examiners with engineering backgrounds. Although the PTO has shown an aptitude for evolving to deal with new technologies, the passage of the AIA suggests that Congress lacks confidence in the PTO's administration of tax patents. Even the PTO implicitly acknowledged that the IRS had the necessary expertise by seeking and receiving the help of the IRS in training some of its examiners. In the context of tax shelter patents, it would make sense to cut out the middleman.

The primary purpose of tax shelter patents would be to improve tax laws and enforcement. A seamless flow of information from patent applications to relevant officials in the Treasury Department would best achieve this objective. Tax shelter patent examiners would not only assess the validity of the patent but would also need to appreciate how the shelter should influence tax administration. Even if a PTO examiner could attain the necessary tax expertise to assess the validity of a patent application, it is unlikely they would be able to know how the tax law should respond to a particular shelter.

235. *Id.* at 93.
c. Focusing on the Abusive Tax Shelter Industry

The proposed patent regime is intended to combat abusive corporate tax shelters. Only a limited class of taxpayers uses such devices so the proposed patent regime should not entangle the vast majority of taxpayers.\textsuperscript{239} A simple rule could give the tax shelter patent the necessary focus: all natural persons (and their advisors) who earn below a certain threshold of income should be exempted from tax shelter patent liability. Income is an effective criterion because it is easy to administer and an accurate proxy.

The accuracy of this proxy is based on the profile of taxpayers who use such sophisticated tax shelters. It is very expensive to develop an abusive corporate tax shelter,\textsuperscript{240} and six- or seven-figure advisor fees are not uncommon.\textsuperscript{241} Most taxpayers have neither the resources to procure such a shelter nor the income that would justify such an expense. Moreover, the Treasury Department probably does not need the disclosures of a tax shelter patent to uncover and pursue less complex tax schemes.

A limit on the enforceability of tax shelter patents against certain taxpayers and their advisors would be analogous to the exception for medical activity.\textsuperscript{242} Section 287(c) of the Patent Laws provides that licensed doctors performing certain medical or surgical procedures could not be liable for patent infringement.\textsuperscript{243} The medical activity exception sought to ensure that patients could freely enjoy the best known medical procedures.\textsuperscript{244} Similarly, a limit on tax shelter patent liability for lower income taxpayers would ensure that most taxpayers can file their taxes without fear of patent liability.

Conclusion

A special tax shelter patent would revolutionize both how the abusive tax shelter industry works and how the government regulates it. This proposal is based on the fundamental idea that abusive corporate tax shelters are more about advisors than taxpayers. The traditional notion that taxpayers are the gatekeeper of their tax return is not realistic when it comes to abusive corporate tax shelters. Policymakers and enforcement officers need to think more creatively about the ways in which to influence the incentives of advisors.

\textsuperscript{239} Cf. Anderson, supra note 140, at 1621 (advocating a similar exemption from tax strategy patent liability for low-income taxpayers because such households need "money-saving device[s]" that might be found in traditional tax strategy patents).

\textsuperscript{240} See, e.g., Hsue, supra note 37, at 943.

\textsuperscript{241} See Statement of Sen. Levin, supra note 6.

\textsuperscript{242} See Anderson, supra note 140, at 1620; Moulton, supra note 13, at 662-63.


\textsuperscript{244} Moulton, supra note 13, at 663.
The government should reconsider its adversarial relationship with abusive tax shelter promoters. It is unwise for an underfunded government agency to continue a costly and unsuccessful game of whack-a-mole against well-financed advisors. A proactive enforcement paradigm will streamline public innovation in the tax law context. The government will be able to respond more quickly to new tax shelters with the eager cooperation of those who make a living by identifying loopholes and manipulating the Code. Congress and the Treasury Department should meditate on the old adage: “keep your friends close but your enemies closer.” An unlikely alliance between tax shelter engineers and the Treasury is the only way to end a fruitless game of whack-a-mole.