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# More Bad News at Tax Time?

The Internal Revenue Service has proposed new rules that would pull within its orbit any software patent that affects taxes, likely choking innovation

by John Kheit

While I have previously defended software patents on this very site, I come now to bury them. It's not because I've changed my mind. It's that the latest nemesis is so imposing, many would give up the fight before it starts.

The most feared meddler of all, the Internal Revenue Service, recently proposed new rules to regulate software patents. These proposed regulations attempt to deal with an alleged growing social ill—dreaded "tax patents" for financial tools and strategies based on IRS rules. But in the subtle way that only the IRS can manage, the agency is taking the elephant gun to the ant hill. The proposed rules purport to pull within the IRS's jurisdiction any licensed patent that "affects" taxes, except for programs like TurboTax. (Apparently, Intuit has very good lobbyists. Kudos!)

These days, just about every piece of business software handles some sort of data that has an impact on a company's taxes. So, in effect, the proposed IRS rules would govern not only patented software that focuses on a company's tax strategies, but potentially just about any licensed, patent-protected software that handles any function of its business. But even worse, any thus-declared "tax patent" would become a "reportable transaction" to the IRS. Commercially speaking, a "a reportable transaction" equals death. What this means is that each and every licensing deal between a software maker and a customer would need to be reported to the IRS.

## Forcing Sunshine on Software Deals

For starters, the rules would saddle software makers with an onerous new regulatory burden and draconian penalties whenever they mistakenly fail to report a transaction. An IRS disclosure also might serve as a deal-killer for clients not keen on publicizing these potentially strategic, or even embarrassing, business decisions. To put it very hypothetically and simplistically, if Google suddenly decided to license Microsoft's Web search and ad delivery technology, it might want to keep such a revelation private.

The IRS has previously, and effectively, used reportable transactions as a device to force sunshine into the murky world of abusive tax shelters. While the agency is understandably concerned with certain patent filers gaming both the patent system and tax compliance, the solution is to shoot the innocent. Their plan, supported by tax attorneys, is to bring the entire reportable transaction apparatus down on "middleware" software patents, stigmatizing those companies that develop and patent legitimate software innovations. Not surprisingly, a public hearing held Feb. 21 to discuss the proposal essentially boiled down to an episode of Bar vs. Bar—that is, tax lawyers vs. patent lawyers.

This regulatory land grab by the nation's tax collector would threaten an explosion of innovation and technology in the financial-services industry that has produced astonishing productivity gains, directly and substantially feeding U.S. economic growth over the last decade. Software and systems that connect the front and back offices—middleware—have prominently figured into these breathtaking efficiencies and have been patented by the likes of IBM, Microsoft, Novell, Oracle, ADP, and many, many others.

## Middleware: Lifeblood of Info Tech

Now, before you doze off at the prospect of discussing middleware, it's important to note that this type of software is the glue that makes many computer systems work. It may sound boring, but it is the lifeblood of the information technology industry. Yet by merely occupying the middleware space, these software patents would be effectively deemed to affect taxes.

To date, software firms and a growing number of financial industry players have been properly incentivized by the patent system to innovate. In many instances, their patent portfolios are quite famous for generating significant recurring income to the ongoing delight of their shareholders. However, under the IRS's new proposal, significant swaths of these licenses would be deemed to affect taxes and be summarily killed—I mean, become reportable. Apparently, your middleware is a tax shelter.

Is anyone else uncomfortable with the notion that the IRS is not sticking to its job of collecting taxes and is, in effect, becoming a bureau dictating technology policy? Representative Jim Gerlach and Senator Arlen Specter apparently are. The two Pennsylvania Republicans recently sent letters to Treasury Secretary Henry Paulson, saying the IRS "is going too far independently affecting patent policy," especially at a time when Congress is working on a patent reform bill. The proposed Patent Reform Act, Gerlach told Paulson, deals with the issue by "specifically prohibit[ing] issuance of patents on tax strategies— rather than taxing the entire realm of middleware patents. In other words: "Back off. Legislating is our job, not yours."

Naturally, when an agency's only weapon is the hammer of declaring things as reportable and/or taxable, you can pretty much bet on an overbroad application—the IRS will see and want to nail every middleware patent as being tax-affecting. If the regulatory burden of the Sarbanes-Oxley Act hasn't already kept enough businesses away from U.S. shores, then the IRS's goal of establishing a Dept. of Software Middleware Taxation certainly will add to that deterrent.

## Former IRS Commissioner Saw No Problem

One would think that to come under fire from the IRS, an epidemic-size problem of so-called tax-patent applications would be threatening to ravage taxpayer compliance, no? Think again. As recently as 2006, then-IRS Commissioner Mark Everson saw the problem as virtually nonexistent. Everson testified that while "taxpayers may attempt to patent abusive tax schemes, [the IRS has] not seen such an abuse in our review of existing tax patents." Indeed, to his credit, he went even further and supported the efficacy of middleware, noting "the ability to obtain a patent could encourage the development of products to help people comply with the tax code."

Data from the U.S. Patent & Trademark Office belies the problem as well. In 2007, it reported that only 86 of more than 1 million pending patent applications were related to "tax strategies." And of the more than 7 million patents the agency has issued in its entire history, a sum total of 60 have been tax-related.

Why then, if both former Commissioner Everson and the USPTO have not observed widespread abuse, is the IRS attempting to get in the middle of middleware patents? The answer seems to be fear on the part of the tax bar and a broad array of tax law groups and practitioners that patent lawyers are starting to encroach on their space and tell them what they can and cannot do. Ironically, they are quite concerned about anyone trespassing on their intellectual territory. It's basically a patent lawyer vs. tax lawyer turf battle. (And yes, I'm a patent guy.)

## A Sledgehammer Instead of a Scalpel

To be fair, it's not unreasonable that tax lawyers have concerns regarding the interplay between the patent and tax systems. However, the current proposals for tax regulations on all middleware patents are overbroad and an overreaction. They're bringing a sledgehammer rather than a scalpel to bear on a minuscule issue, software industry be damned. Considering the "tidal wave"" of 86 patent applications filed in the last 10 years, this overprotective "concerned citizen" stance is a bit like taxing chickens to protect the dodo.

The IRS hasn't said when it will decide. Right now the best thing for the IRS to do is either drop the issue or pass the regulation. If it's dropped, Congress can appropriately deal with the issue. If the rules are adopted, the IRS will be swiftly sued and spanked for exceeding its authority. But should the IRS and tax bar get their way, eBay users shouldn't be surprised when the auctioneer starts reporting their transactions to the IRS. The chickens will be next.

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