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Proposed Combination of Tax Software Makers Violates Section 7 of the Clayton Act

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The federal district court in Washington, D.C. yesterday released its Memorandum Opinion explaining its October 31 order enjoining H&R Block, Inc.'s proposed acquisition of 2SS Holdings, Inc.—the maker of "TaxACT" tax preparation software.

The court took a traditional approach in reviewing the merger and concluded that the transaction, which would have combined the second and third-largest providers of digital do-it-yourself (DDIY) tax preparation products, violates Section 7 of the Clayton Act. It began by defining the relevant market. After determining that the Department of Justice made out its *prima facie* case of anticompetitive effects based on market concentration, the court considered whether the merging parties could rebut the presumption.

Relevant Market

Based on "the full body of evidence," the court accepted the government's proposed relevant market definition—DDIY tax preparation products. The defendants unsuccessfully argued that the market should include all methods of tax return preparation, including: (1) the "pen and paper" or "manual" method using Internal Revenue Service forms; and (2) the "assisted" preparation method, which involved hiring a tax professional.

The court explained that substitution and price competition with these methods would not restrain any potential DDIY monopolist from profitably raising prices. Enough DDIY users would not switch to the assisted or pen-and-paper methods of tax preparation in response to a five-to-ten percent increase in DDIY prices to make such a price increase unprofitable. Assisted products and manual preparation were not sufficiently close substitutes to constrain anticompetitive pricing after the proposed merger.

The court also noted that the defendants' documents suggested that the parties treated DDIY as a distinct product market in the ordinary course of business. For instance, documents discussed the "Big Three" competitors in the DDIY market: Intuit, maker of "TurboTax"; H&R Block, maker of "H&R Block At Home" (formerly known as "TaxCut"); and 2SS Holdings—maker of TaxACT.

Expert Evidence

In determining the relevant market, the court did not rely upon the defendants' expert's analysis. The defendants' definition of the relevant market rested primarily on their experts' analysis of

simulated diversion data obtained from a “pricing simulator” and an e-mail survey. Diversion measures to what extent consumers of a given product will switch or be “diverted” to other products in response to a price increase.

The court found the shortcomings of the defendants’ experts’ diversion data to be so substantial that it could not rely on them. There was a critical flaw in the design of the pricing simulator. The pricing simulator survey failed to assign prices to certain product options. Further, there were issues with the phrasing of survey questions, as well as the methodology of the survey, that rendered the reliability of its findings questionable, the court explained.

The government’s expert, whose testimony supported a market limited to DDIY, relied heavily upon switching data from the Internal Revenue Service (IRS) as a proxy for diversion. The highly reliable IRS switching data did not directly measure diversion, because switching could have occurred for any number of reasons, many of which might not involve price. Yet, the switching data was at least somewhat indicative of likely diversion ratios, in the court’s view.

Anticompetitive Effects

The government made out its *prima facie* case of anticompetitive effects resulting from the transaction based on the resulting concentration. The proposed acquisition would have given the combined firm a 28.4 percent market share. Intuit had a share of approximately 62.2 percent of the market. The transaction would have increased the Herfindahl-Hirschmann Index (HHI)—a measure of market concentration calculated by totaling the squares of the market shares of every firm in the relevant market—by approximately 400, resulting in a post-acquisition HHI of 4,691.

These HHI levels were high enough to create a presumption of anticompetitive effects, the court ruled. Under the joint Department of Justice/ Federal Trade Commission Horizontal Merger Guidelines, markets with an HHI above 2500 were considered “highly concentrated” and mergers “resulting in highly concentrated markets that involve an increase in the HHI of more than 200 points will be presumed to be likely to enhance market power.”

Coordinated Effects

The defendants were unable to rebut the “ordinary presumption of collusion” in a highly concentrated market by arguing that were “structural market barriers to collusion” specific to the industry. The preponderance of the evidence suggested the acquisition was reasonably likely to cause coordinated effects, according to the court.

The government contended that coordination would likely take the form of mutual recognition that neither Intuit nor the combined firm would have an interest post-merger in an overall “race to free” in which high-quality tax preparation software was provided for free or very low prices. According to the government, the two largest firms would find it in their mutual interest to reduce the quality of their free offerings and maintain higher prices for paid products. There were other indicia of likely coordination present in the DDIY market. Transactions in the market were small, numerous, and spread among a mass of individual consumers, each of whom had low bargaining power; prices could be changed easily; and there were barriers to switching due to the “stickiness” of the DDIY products.

It also was noted that the merger would result in the elimination of a particularly aggressive competitor. There was evidence demonstrating TaxACT’s impressive history of innovation and

competition in the DDIY market. In its complaint, the government described TaxACT as a "maverick." According to the Horizontal Merger Guidelines, a maverick is as a particularly aggressive competitor that "plays a disruptive role in the market to the benefit of customers."

The court explained that the government had not "set out a clear standard, based on functional or economic considerations, to distinguish a maverick from any other aggressive competitor." In any event, the court said that the important question was whether "TaxACT consistently plays a role within the competitive structure of this market that constrains prices." The court decided that it did.

Unilateral Effects

The defendants were unable to rebut the presumption that the merger would eliminate head-to-head competition between the merging firms and likely increase overall prices in the DDIY products of the merged firms to the detriment of the American taxpayer. The government demonstrated a reasonable likelihood of unilateral effects.

The defendants' pledge to maintain TaxACT's current prices for three years could not rebut the likelihood of anticompetitive effects, the court ruled. Even if list prices remained the same, the merged firm could accomplish what amounts to a price increase through other means, such as limiting functionality or reserving special features or innovations for higher-priced products. The court also rejected the defendants' arguments that they were not particularly close competitors because they competed in distinct segments of the market or their combined market share did not surpass a certain threshold for proving a unilateral effects claim.

Post-Merger Efficiencies

The defendants failed to establish efficiencies from the merger that might rebut the government's showing of likely anticompetitive effects. At least some of the purported cost savings could have been achieved by H&R Block on its own by relocating employees or taking a more cost conscious attitude, the court explained. Even if the efficiencies were entirely merger-specific, many of them were not independently verifiable, it was noted.

Victory Precedes AT&T Case

The case marks an important victory for the Antitrust Division as it prepares to go to trial early next year in its challenge to AT&T Inc.'s proposed acquisition of T-Mobile USA, Inc. The AT&T case, however, is likely to be a tougher battle.

The government's proposed markets for mobile wireless services in the AT&T case are not nearly as straightforward as the market for DDIY tax preparation products in this matter. And the DDIY market is apparently more highly concentrated than the markets for mobile wireless services. Yet, the government alleges in the AT&T case that in most of the markets the HHI numbers substantially exceed the thresholds at which mergers are presumed to be likely to enhance market power. Moreover, this court accepted the government's argument that the elimination of an aggressive competitor could leave the remaining firms with an incentive not to compete. In the AT&T case, the government makes a similar argument that the elimination of T-Mobile as an aggressive competitor and innovator would lead to coordination among remaining mobile wireless services providers that would result in higher prices.

The November 10, 2011, decision in *U.S.v. H&R Block, Inc.*, No. 11-00948 (BAH), will appear at **(CCH) 2011-2 Trade Cases ¶77,678**.