

CALIFORNIA CONTINUING EDUCATION, INC
PRESENTS

INVENTION EUTHANASIA : The 2017 Tax Bill

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Premise: “Tax Cuts and Jobs Act” bill eliminates “asset” status for patents and copyrights and thus eliminates capital gains. The effects will be far reaching.

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INVENTION EUTHANASIA

:The New Tax Bill

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I. Two Paragraphs from the Tax Cuts & Jobs Act (TCJA):

“This provision amends section 1221(a)(3), resulting in the exclusion of a patent, invention, model or design (whether or not patented), and a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) from the definition of a “capital asset.” Thus, gains or losses from the sale or exchange of a patent, invention, model or design (whether or not patented), or a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) will not receive capital gain treatment.”

“The provision repeals section 1235. Thus, the holder of a patented invention may not transfer his or her rights to the patent and treat amounts received as proceeds from the sale of a capital asset. It is intended that the determination of whether a transfer is a sale or

exchange of a capital asset that produces capital gain, or a transaction that produces ordinary income, will be determined under generally applicable principles.”

II. HOW DID WE GET HERE?

A. Tax History

The United States has historically embraced the individual. It was believed that individual rights, individual achievement and individual betterment were part of the American Dream. Rather than set up give-aways to those who would simply come to America and do nothing more than and sponge up benefits, our country made a long ago deal with innovative inventors. Work smart and the reward would be a brief monopoly. America needed more inventors in order to develop with new industries, economically flourish with the nation and help us compete against other countries for industrial dominance.

As an added incentive, we have had over the past decades a mechanism that especially benefitted the most prolific of our inventors with “instant capital gains.” You invent on a Monday, file the patent on Wednesday, and sell the invention on Friday to collect sales proceeds that were instantly available for capital gains. Inventors could even share the risk of businesses by receiving licensing sale proceeds over time based upon how well the annual sales of a business was proceeding.

Instant capital gains required the inventor to actually “sell out” and give the buyer an independent free hand in exploiting the new product or service. This was a valuable mechanism, because the actions and decisions of business need not be burdened with the often whimsical personal ideas of inventors as to how the business should proceed.¹ There are a host of good advantages for separating the inventor from the for-profit business.

First, a really prolific inventor creates wealth, both personally, and for the world economy, by inventing. Once a product or service is invented, a number of different people are required to exploit it. Marketers, supply chain professionals, CPA’s and shop keepers may all get involved at different times and to different extents. Stated rudely, trying to turn an inventor into a shop keeper helps no one. Inventors that wanted to immerse and control business related to the invention were forced to either become “creative” in hiding a control relationship, or else give up any “instant capital gain” tax rates for ordinary income tax rates (and in some cases self employment tax as well).

Second, the U.S. tax benefits for inventors were an incentive that should have operated to attract foreign inventors to the U.S. For 2013 and prior, the capital gains rate was a flat

15% for patents. For a given invention, an inventor could generate sale royalties and keep 85% federally. For an inventor living in a non-state-income-tax state, the total capital gains tax in 2013 was 15%. Obama administration changes boosted the capital gains rate for patents to about 25%, although it could have been less based upon a lower total overall income.

Even Canada applies a combined federal and provincial rate after a 50% reduction in capital gain income (all major provinces in Canada have an income tax). This resulted in 2016 in a combined federal and provincial capital gain rate from 23.85 to 27%. Unlike the U.S., Canada doesn't allow for expensing of most patent costs, and Canada also provides for recapture of any depreciation on sale. Thus the overall marginal rate on sale is higher, although the total tax is smaller where prior expenditures are return of capital.

Other U.S. tax advantages included an expensing for patent costs and research and development which were not recorded under any particular capital account. The result was the ability to deduct all research and patent costs against ordinary income, and to take every capital gain sale dollar at the capital gains rate. Another U.S. tax advantage for the individual inventor, was the ability to "sell" the patent rights in every country individually to create a stream of capital gains income directly into the personal pocket of the inventor. This was useful in enabling the inventor to avoid having to enter a presence into each country, and set up a corporation for holding the patent in the event that the business containing the patent were sold after one year of holding (and all of the FBAR and FATCA tax reporting necessary -- but more on that later).

So, even a Canadian inventor with a combined capital gain rate of from 23.85 to 27% still had an incentive to come to the U.S. Research and patent acquisition were expensible / deductible against ordinary income (not required to be carried as capital items) and, the capital gains rates would be applied to all the amounts in the sale. Put another way savings included (1) eliminating a capitalized a cost of about 8% of the capitalized balance [interest free loan to the government], (2) a possibility of keeping ordinary expenses completely isolated from capital gain income, and (3) capital gains from each country of sale, directly into the inventor's pocket.

Individual country capital gains were also useful for sculpting income from residual countries not exploited by a major licensee. An example might include a large corporate licensee that has activities in all of Europe and India. The inventor could still license the Pacific Southern Hemisphere and as a boost to the inventor's worldwide income, possibly with leaving the licensee to create the foreign country patents. How much of this could be

done in Canada, without having a hard asset to sell, I have not researched. The point is that even a Canadian inventor had some additional motivation to come to the U.S., to do research in the U.S. and to exploit from the U.S. Without capital gain treatment, it may be that none of the most prolific inventors will want to come to the U.S.

A 37% income tax rate for ordinary passive income in the proposed new U.S. tax bill loses to Canada by 10-13%. And this is for U.S. inventors that have a 0% state income tax rate. For California inventors, for example, the incentive to go to Canada to invent increases to from about 23% to 26%. The thought that someone could move from California to Toronto and save 23% to 26% of their income from tax is abhorrent. There are a lot of new, positive aspects to the proposed new U.S. tax bill. Disincentivizing our current and future most prolific inventors is not one of those positive aspects. Is Canada prepared for an influx of immigrating U.S. inventors? But is America prepared to further accelerate its loss of competitive edge?

B. Technical History

The continued infusion of digital and the internet has diluted innovation in the United States. Prior to 1999, the development of computers and computer invention intimately tied into the patent system. Innovators used the patent system to as a directional guide post to dope semiconductors to higher density packages, to make smaller, sturdier, hard drives, and improve computer reliability.

Patent “intellectual rules” included a prohibition on business methods, and a general prohibition on close-ended math and database functions not having a real-time functional advantage. A series of philosophical patent cases filled in precise sub-rules that defined the limits of what was and was not permissible. Inventions with open math functions like Fourier transforms that operated as summing functions in real time were favored. Computer data-base sorting and manipulations were not favored. Close-ended math functions that operated in real time to improve sound quality were favored.

In 1999, the State Street Bank² case came along. The PTO had just denied another data base program allowable claims and they appealed to the Court of Appeals for the federal circuit (CAFC), commonly known as the patent appeals court. What should have been a denial turned into unbelievably new law. The court held that (1) all software is potentially patentable if it meets the usual criteria, and (2) the 200 year old prohibition on business method patents is eliminated. The latter was not really part of the case, and I had thought that this lapse of reality would be quickly remedied with a later reversal. It never happened.

To me, it appeared as if some persons had cast their gaze to “liberal Europe” and viewed with some envy the breadth of computer claims that were being allowed in patents there. There may have been a fear of loss of innovative businesses to Europe. The reasons for “inventing liberal case law” will forever be pure speculation. No jurist would admit *what* they were thinking at a prevaricative “left turn” away from the weight of developed technological jurisprudence and 200 years of tradition.

Liberalization of computer software/business methods unexpectedly continued into the 2000's with brakes beginning to be applied in 2008 and ending with the 2014 Alice case³. Alice was extreme and contra to the 2000's. Alice brought up the §101 definition of statutorily patentable subject matter (machine, process, composition of matter & article of manufacture) and stated or implied that the patents applied for since 1999 relating to non-scientific, non real-time dependent, etc. software “might be” invalid, and perhaps might be re-submitted for the PTO to check. Alice’s 2014 date compared to 1999 represented 15 years of patents, substantially close to a generation (seventeen to twenty years) of patents. The vast majority of applicants or issued patent owners would not and did not begin a wave of re-submissions.

C. Painful Return to Reason

The return to reason would have been more effective if the authors of the State Street Bank decision could have simply withdrawn it after announcing “My Bad”. The decade after State Street Bank represented a painful and uncertain path back to a state more clearly similar to the state of the law before State Street Bank was decided. When the millions spent on patent cases and appeals is considered, along with the uncertainty of not knowing a proper level of protection to be sought for computer related inventions, the path to Alice was painfully expensive, and expensively wasteful.

The “out of nowhere” blessing for business method claims doubled the pain and contributed to anger directed at the patent system. The most noteworthy topic for generation of anger were “tax patents.” Although these were inherently structurally ineffective as a monopoly, they were effective in generating anger. The few who pursued tax patents spent their time in seminars threatening the attendees not to use the techniques they were being taught. Tax patents were an easy media focus: “Americans could be prevented from tax exclusions from income and from tax deductions for fear of being sued by a tax patent holder.” Legislation prohibiting tax patents was signed into law in September 2011.

D. “Patent Troll” Perception

The perceived rise of the “Patent Troll” may have been the impetus for the extreme de-assetization of patents. A most conservative definition of “Patent Troll” is an entity that attempts to press greater rights than it has. I contend that the main perception of “Patent Troll” is some non-operating entity or person that obtains a patent but does not operate to manufacture or import a good or service related to that patent. It is my belief that a desire to see only operating companies hold patents that caused tax bill legislation that included a de-assetization of patents, especially against so long a history in the U.S. to reward individual innovation.

De-assetization doesn't prevent the pressing of a patent case against an infringer, but it does make it more difficult and less rewarding if the result of settlement is the sale of the patent to the accused infringer. As an asset, the sale by an individual could have resulted in capital gains rate of from 0 to 25%. If the settlement was a sale of the patent that depended upon the sale of a product for 20 years, a royalty of about \$40,000 per year for 20 years could have been received tax free if the inventor had no other source of income. Otherwise, the annual capital gains tax would range between 10% and 25%.

E. Non-Inventive Computer Programming

The bulk of this generation of people in the computer industry are focussed on non-technical and non-inventive programming. The term “Application” or “App” has commonly come to mean a program that will provide “some” non-essential non-engineering information to a user of the Internet. For the most part, these “Apps” are related to advertising, or personal needs or recreational interests. Most of these “Apps” are monetarily driven by advertising dollars spent and received. Advertising dollars are most generally always ordinary income and expense.

An I-phone is a computer with telephone and wireless capability. Small, hand-held computers have the capability to perform much the same tasks as any computer, namely, a computer using open-ended math functions, statistical evaluation capability, and much more. The average programmer tends not to program to create a system across different devices; they stick to established program manual of a given device and limit themselves to programming simple instructions within the device. Most device programmers shy away from computational programming.

F. Patent System is being minimized

In 2016, further legislation was passed to inhibit a patent plaintiff's ability to select a favorable jurisdictional (pro-plaintiff) forum for patent infringement. The PTO has taken on the task of “transparency” which typically means that there will be more resistance to

allowing patents. But because the slowdown will be done “openly” perhaps no one will notice? PTO has opened small offices in various cities, in the U.S. and overseas, ostensibly to help make patenting more available to the populace. My own experience is that over the past two years, the patent examiner’s are less willing to engage on a technical level and are forcing applicants that are intent on receiving their full share of claims into threatening and filing appeals.

III. TACTICAL CHECKLIST

A. Prior to December 31, 2017

When inventors had “instant capital gains”, the patent itself was a capital asset that drew capital gains on sale immediately after creation (trade secret) or after filing. If the “Tax Cuts and Jobs Act” (TCJA) is signed into law, patents, trade secrets and copyrights will lose the ability to become capital assets. Most copyrights have traditionally not been capital assets in the hands of the creator, but could have become capital assets on first sale. Patents and trade secrets were typically capital assets upon an earliest articulation of the technical details of the asset.

Until December 31, 2017, purchasers may hold the patent as a capital asset under IRC §1221(where it is not used in business) or IRC §1231 (if used in a business). Further, these capital assets were not subject to recapture, generally because the expensing of costs related to patent assets were divorced from the assets under the “related to” language of IRC §174 enables a taxpayer to deduct patent development costs as a separate research item. It is always a challenge to allocate costs of research to the patents to which they relate, so this provision has other advantages. Expensing costs against ordinary income meant that most patent assets ended up as a zero basis item in order to capture all of the value on sale as a capital gain, with no recapture of the expenses of research and development deductions.

B. After/Assuming (TCJA) non-asset status

Research is required to be capitalized under IRC §174. It remains to be seen whether patent attorney costs may be deducted under IRC §174. However, the new IRC §174 requires 5 year amortization for research expenditures. 5 year amortization is a major slow-down and cost, by delaying expenses. What it means is that research expenses will be not unlike buying a hard asset-- the taxpayer will need to justify the cash flow needed to exceed the net present value of the tax loan made to the government.

The patent or copyright asset should be thought of as a pencil or piece of paper. They

usually have no asset value, but if owned by a corporation, it is the corporation that gets asset treatment when it is sold (assuming that its not a “disregarded entity.”

C. The checklist

1. It may be expedient to assign a patent into an entity that will not experience disregarded entity status. So, LLC’s and other pass throughs perhaps should be avoided.
2. The entity should be selected to hold the patent and nothing more. Buyers typically want to buy assets because they don’t want to take any chance on the tax history of any corporation purchased. As such, the creation of a corporation, the entry of a patent asset, and the business history of the corporation up to and including sale, should be provably free of any significant activity. The books and records of the ideal corporation created and used to transfer the patent should be so simple that it could be contained on a simple sheet of paper.
3. Corporation cost of acquisition and annual minimum franchise tax should be considered carefully. California’s \$800 annual minimum franchise tax will cause the budgeting of over \$1000 per year expense that will be like keeping the patent in a storage unit. Other states that have a lesser cost should be considered, especially since simple asset ownership will not probably not contribute to any undue ties to the jurisdiction of that corporation.
4. I have historically taught that trademarks should be kept in a separate corporation rather than risk the loss of value should the business entity be sued. In the past, because patents had instant capital gains rights they may have been best kept out of a well separate corporate entity if the business was small. Now, an entity will be needed, (a) not only for separation for liability insulation, but (b) also for any capital gains upon sale of the corporation.
5. After (TCJA), any sale, exclusive or not, will result in ordinary income. This might facilitate more non-exclusive licenses from the platform of a corporation owning the patent. If the separate corporation holding a patent is a licensing business, ordinary income flows can be increased and accumulated so that the corporation might then be sold for a capital gain rate. Further, simple license income will not usually complicate the tax history enough to cause any reduction in value.
6. Regular corporate ownership would seem to be best type of entity to own a patent

because (a) it will be given the greatest respect as a separate entity, (b) if it earns no money, the real annual cost of holding the patent will be any minimum franchise tax and the time to file a corporate tax return, and (c) if it earns money, it will be a business unto itself and can be made to provide a salary and profit sharing at pay the owners, and possibly provide benefits.

7. Tax liability for a impermissible “type A” reorganization is an even greater danger. The typical “type A” reorganization occurs when a larger corporation tries to obtain a tax free transfer of assets from a smaller corporation by merger, usually in exchange for a stock of the acquiring company in exchange for 100% of the stock of the target company. Restrictions may exist, including (a) the acquiring corporation should continue the target business for two years and the stock of the acquirer is an even greater danger, (b) about half of the consideration to the target shareholders should be stock, and there should be no arrangement to re-acquire the stock so that it will not be considered an asset sale. In other words, both target and acquirer will need to be in each other’s orbit for a few years in order for the target shareholders to insure that any capital gain treatment is not un-done. Capital gains are generally 0%-15%-20% corresponding to income less than about \$75k, less than \$480k, and over \$480k.

8. Where an inventor is not incentivized by a lower tax rate to maintain an arms-length, separate, and passive stance as a licensor/seller, the inventor is likely to become affiliated with the buyer. The inventor is likely to be cheated, swindled and abused. The tax incentive gave the inventor an incentive to remain separate and apart from the buyer/licensee. Remaining separate gave the inventor some control over the patent, the product, and the business, to insure that he would be paid. It will be easy now to hire the inventor for a pittance, pressure the inventor to give up the invention, and then fire the inventor in order to complete the fraud.

9. Any disagreements over the transfer of the patent will end not with return of the patent, but with pittance damages to the inventor and with the buyer/licensee leaving the patent with the transferee. If the buyer/licensee fails the inventor will not be able to re-acquire the patent and start again with someone else.

10. Large companies that create their own patents and hold them to aid the production of income will be largely unaffected.

11. The United States may begin losing inventors to countries with more favorable tax structures. Countries hungry for new industries may offer inventor of the best inventions

an immigration and tax free deal. Inventors can free themselves from U.S. taxation by surrendering citizenship.

12. In surrendering citizenship, the IRS requires a “forced sale” of all U.S. assets at the time of citizenship exit. Any valuable inventions that the inventor commands and controls will be difficult to value, and even more difficult to discover.

IV. Questions For The Future

Will inventors and corporate shell creators work together to create year-old corporations for inventors to purchase and place their patents in order to effectively achieve rights similar to instant capital gains?

Is all of this done simply to further nickel and dime small inventors in hope of discouraging their creativity? Has someone in government made the value judgement that society will function more effectively either (a) with a reduced number of patents, or (b) by leaving patents to the exclusive realm of large corporations?

Is this proposed change in the law a value judgement that real inventions are not as prevalent and the majority of startup inventors are doing Internet applications that should not be patentable in the first place? Or is this a governmental policy preference to minimize sole proprietors in favor large corporations employee status (from whom it is often easier to collect tax)?

V. Comparison of Options

This section shows a chart from my previous Intellectual Property Taxation outline which has been modified for simplicity.

PRE (TCJA) INTELLECTUAL PROPERTY TAX TREATMENT TABLE

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| Property Type | Write Off Method | Capital Gain | Comments |
|--------------------------|--|---|---|
| Patent or Trade Secret | Expense Immediately §174 | § 1235 Instant long term Cap gain: inventors & holders (or outside § 1235 if held >12 mos.) | Best possible treatment. §174 expense is NOT RELATED to the patent asset, so no recapture . Sale outside § 1235 has relaxed buyer ownership percentage rules. |
| Copyright General- | Capitalize Identifiable Projects: (1) 15 year write off if acquired in a business (§197). (2) otherwise write off over useful life. | Not available to creator or creator employer; Ok to others if held for >1 yr. | Where you create or employ someone to create a copyrighted work, you are the author and the sale will be ordinary income. (Except music) |
| Software, non Patentable | Held in trade or business for the production of income (§167(a)) ok to depreciate over 36 months, straight line, typically an off-the-shelf sale. Specialty software not for production of income, depreciate over shorter of copyright life or useful life. | No capital gains in hands of creator or creator's employer. If purchased, owner has fragmentation by medium right to sell off different media portions and keep others | If truly non-patentable, you should register within 3 months of publication in order to get valuable litigation rights such as statutory minimum damages and attorney fees. |
| Patentable Software | Expense under § 174 | Same as for Patents | IRS may want to characterize as copyright software, but patent application helps. |
| Trademarks | Cap. acquisition & costs of defending. Amortize over 15 years if bought after 1993 w/ a business) | Capital gains if held for more than one year. | Sale of trademark name without more is an abandonment, every purchase/sale should include something else from the business. |

POST (TCJA) INTELLECTUAL PROPERTY TAX TREATMENT TABLE

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| Property Type | Write Off Method | Capital Gain | Comments |
|------------------------|--|--|---|
| Patent or Trade Secret | 5-Year Capitalization (15-Year Capitalization Foreign research) | Not available to creator or later basis purchaser. | Even the. §174 “unrelated” non-recapture is gone. |
| Copyright General- | Deduct as salaries if self-created. Expense if paying others possibly. | Not available to creator or later basis purchaser. | Copyright was always the worst, but now its equally bad with patents. Music copyright asset is gone. |
| Trademarks (no change) | Cap. acquisition & costs of defending. Amortize over 15 years if acquired after 9/9/93 (with some piece of business) | Capital gains if held for more than one year. | Sale of trademark name without more is an abandonment, every purchase/sale should include something else from the business. |

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- Litigation** Associate counsel in patent & trade secret litigation; Municipal Court Judge pro tem & Superior Court Mediation program Attorney-Client fee Dispute Arbitrator, Long Beach Bar Association; Patent Panel, American Arbitration Association.
- Teaching** Adjunct Law Professor, Golden Gate University School of Law, LL.M. Taxation Program; Georgia Institute of Technology - previously taught heat and mass transfer laboratories, and analog and digital computer laboratory.
- Member:** **Current Member:** State bars of California (Business, Tax, & Criminal Sections), Texas, Arizona & Nevada; Central District Consumer Bankruptcy Attorneys Association (2011-2017); & Fellow, National Tax Practice Institute. **Past Member:** Member (2006-2011) & Chair (2010-11) of the Taxation Advisory Committee of the California State Bar Board of Legal Specialization; Member (2011-2016) & Chair (2014-15) of the California State Bar Board of Legal Specialization; Southern California Bankruptcy Inn of Court (2011-2012); Long Beach Bar Association. (Board. of Governors, 1994-95); Orange County Bar Association, (Co-Chair Technology Law Section 1996); National & CA Society of Enrolled Agents (Orange Co. Chapter President 2003-2004); Registered Parliamentarian - National Association of Parliamentarians; Business Management Committee of SEMA member (1997-98); CA Bar: CEB committee of (1999-2000); Taxation Section Executive Committee (2002-2005); Income & Other Tax subcommittee (Chair 2000-2002); Special Master, California State Bar Association for Search Warrants under Penal Code §1524 (2001-2002).