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INTELLECTUAL PROPERTY TAXATION

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Changes occurred at the end of 2017 have probably not worked their way through the courts yet.

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INTRODUCTION

(A) A little of what non-tax Intellectual Property is about.

(1) Different types of intellectual property rights, how they are created, protected, (or not), and what to look for in each.

INTRODUCTION

(A) A little of what non-tax Intellectual Property is about.

(2) Introduction & Understanding the Negative Nature of IP and thinking inversely

INTRODUCTION

(A) A little of what non-tax Intellectual Property is about.

(3) Overview of Intellectual Property Category Differences & Combination.

INTRODUCTION

(A) A little of what non-tax Intellectual Property is about.

(4) Has the "Prolific Inventor" model diminishes in favor of collaboration?

INTRODUCTION

(B) Non-Tax history of Prior Patent System in the U.S.

(1) Originally a “first-to-invent” system, its now a “first-to-file” system. Evidence of conception is largely moot.

INTRODUCTION

(B) Non-Tax history of Prior Patent System in the U.S.

(2) Competing inventions relied upon a “conception date” and then going into the past with no “significant break in diligence.”

INTRODUCTION

(B) Non-Tax history of Prior Patent System in the U.S.

(3) Monopoly is enforced by power to prevent others from “making,” “using,” or “selling” the claimed invention.

INTRODUCTION

(B) Non-Tax history of Prior Patent System in the U.S.

(4) Usually 100% of the ownership interests of a patent were required in order to bring suit for infringement.

INTRODUCTION

(B) Non-Tax history of Prior Patent System in the U.S.

(5) In order to produce value from manufacture, a fractional interest in a patent still requires a partnership or joint venture agreement.

INTRODUCTION

(B) Non-Tax history of Prior Patent System in the U.S.

Like any partnership, an agreement may have different partner requirements for loss makeup, profit distributions & distributions from sale.

What is a Patent?

- Relates to (1) machine, (2) process, (3) article of manufacture, (4) composition of matter, (5) non-tuber plant
- Three kinds of patent:
 - Utility:
 - Covers function
 - 20 year potential
 - Design
 - Covers look of utilitarian item
 - 15 year potential if filed after 5/13/2015
 - Plant: 20 year potential

INTRODUCTION

(C) Where previous technology was centered & is centered today

Right to make, use & sell. Patent claims to Apparatus, Machine, Article of Manufacture, & Process.

INTRODUCTION

(C) Where previous technology was centered & is centered today

Electrical equipment has been more and more replaced with microprocessor based controllers that replaced lumped parameter elements.

INTRODUCTION

(C) Where previous technology was centered & is centered today

Programming enables processors to be used for different equipment and purposes.

INTRODUCTION

(C) Where previous technology was centered & is centered today

Prior to 1999, the key issue was whether the resulting programmed device became a new and useful machine.

INTRODUCTION

(C) Where previous technology was centered & is centered today

State Street Bank & Trust Co. v. Signature Financial Group, Inc.
149 F.3d 1368 was a CAFC case which judicial activism wildly & improperly expanded computer patent possibilities.

INTRODUCTION

(C) Where previous technology was centered & is centered today

State Street held (1) all software is potentially patentable. (2)

Business method patents (which were not part of the case) were permissible despite being improper many years.

INTRODUCTION

(C) Where previous technology was centered & is centered today

It may have been noted that European patent liberality was something envied, regarding the motivation for the decision in State Street.

INTRODUCTION

(C) Where previous technology was centered & is centered today

An expected quick reversal of the State Street holding was not immediately forthcoming.

INTRODUCTION

(C) Where previous technology was centered & is centered today

Beginning with *In re Bilski*, 545 F.3d 943 (Fed. Cir. 2008) through *Bilski v Kappos* 561 U.S. 593 The doors on State Street slowly began to narrow. 26

INTRODUCTION

(C) Where previous technology was centered & is centered today

Alice Corp. v. CLS Bank International 573 U.S. 208 (2014) represented a significant limitation on computer patents.

INTRODUCTION

(C) Where previous technology was centered & is centered today

The Alice case provided an even more severe basis for attack: that the essence of the invention could be outside the classes of statutory subject matter.

INTRODUCTION

(C) Where previous technology was centered & is centered today Alice also questioned legitimacy of all then-current patented software inventions. Remedy that software patent owners ‘resubmit’ issued patents to PTO for “within statute” verification.

INTRODUCTION

(D) The societal trend in general technology

(1) Separate device ennui, or fast chip dominance?

(2) Mechanical-chemical-electrospeed dominance? Or is it Big Pharma?

INTRODUCTION

(E) For individual inventors, the patent system has been hobbled. Is it best for American productivity?

Forces behind government have caused a significant weakening of the patent system for all but the largest entities.

INTRODUCTION

(F) Possible Reasons & Factors

Disadvantaging occurs both technically and financially

Disadvantaging occurs for all but the largest entities.

INTRODUCTION

(F) Possible Reasons & Factors

(1) Startups are obsessed with Software & “internet magic” instead of shippable items;

(2) Sales Tax Revenue falls.

INTRODUCTION

(F) Possible Reasons & Factors

(3) Less invention products are available for export & don't (Apps governmental balance of trade)

INTRODUCTION

(F) Possible Reasons & Factors

(4) Today's drop ship, NAFTA / USMCA, porus entry, Just-In-Time & direct shipments to customers cause infringer channels to be more difficult to identify OR locate.

INTRODUCTION

(F) Possible Reasons & Factors

(5) Government may believe that a strain on the economy from threat of IP lawsuits will not be outweighed by greater rewards for the innovative entity monopolies.

INTRODUCTION

(F) Possible Reasons & Factors

(6) Innovation for new products has slowed, such that tax benefits provided to individual inventors & their inventions are too costly to government

INTRODUCTION

(F) Possible Reasons & Factors

(7) Patents of not-in-business, non-producers (often referred to as trolls) were not being used to better compete in the market, but to damage otherwise competitive industries.

INTRODUCTION

(F) Possible Reasons & Factors

(8) Tax patents formed the whipping stepchild of the movement to restrict the patent system.

INTRODUCTION

(F) Possible Reasons & Factors

(9) In the past 5 years, patent examiners have been encouraged to cut & paste “pictures” from publications to use with their office actions & perhaps speculate beyond the text of its disclosure.₄₀

INTRODUCTION

(F) Possible Reasons & Factors

(10) In the past 5 years examiners have adopted a tactic of not engaging arguments directly, & generally “dismissing” applicant’s position without direct engagement.

INTRODUCTION

(F) Possible Reasons & Factors

(11) Examination office actions have grown in length from about 10 pages for a response to 30, even for a modest sized set of claims. Many examiner arguments are highly speculative₄₂

INTRODUCTION

(F) Possible Reasons & Factors

(12) Examiners know which practitioners regularly appeal & give those practitioners & clients more real engagement. Most small inventors & startups may not have the funds to appeal.

INTRODUCTION

(F) Possible Reasons & Factors

(13) Inter Partes Review (IPR) after patent issuance is reputed to cost more than an appeal. One source states that 85% of the claims after an IPR receive cancellation.

INTRODUCTION

(F) Possible Reasons & Factors

(14) Restriction against shopping:
In 2017 the Supreme Court defined term “resides” as limited only to its state of incorporation, limiting where suits could be tried.

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

(1) 2017 & prior: Sec1235 made patents made “instant capital gains” available to “holders”

A holder is someone that was associated with the patent before actual reduction to practice

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

(2) 2017 & prior:

Patents could also get regular 1-year holding capital gains without meeting the § 1235 standards (which were more strict as to related party provisions)

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

(3) 2017 & prior: §174 (a) research or experimental expenditures which are paid or incurred by him during the taxable year “in connection with” his trade or business.

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

(3) 2017 & prior: §174 (a) “in connection with” was a special term that enabled deductions to be de-coupled from a requirement of having an open an operating trade or business.

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

(3) The “in connection with” language generally allowed a deduction for the expensing of patent costs despite the fact that the taxpayer is not in a currently operating trade or business.

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

(3) 2017 & prior: Thus, patent applicants could deduct as expense their patent acquisition cost against other ordinary income, & obtain separate capital gains on sale (without recapture).

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

(3) 2017 & prior:

Under patent rules a sale of a patent could be done in exchange for a royalty stream so long as it was a complete sale.

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

(3) 2017 & prior:

Complete sale required that the licensor placed a power and ability in the licensee to obtain patent title based generally only upon payment of money.

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

(3) 2017 & prior: Licensors retaining rights, or control over the licensee in more than a de minimis amount might have the transaction ruled a non-sale license, with loss of capital gain rates.

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

(4) 2017 & prior: Simple, Ridiculous Example to help remember the separation. Inventor Taxpayer, in 2010 with \$2M of unrelated income sinks \$1M into a pilot plant for experiments.

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

(4) 2017 & prior: Cont'd: Inventor sells patent for \$1M cash.

Ordinary tax rate is 40%; capital gains rate is 15%. How much was earned on the transaction?

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

\$1M expenditure results in a \$400k deduction benefit. 15% tax paid on the \$1M sale leaves \$850k in-pocket. \$2M at the beginning versus: $\$1\text{M} + \$850\text{k} + \$400\text{k}$ tax savings = \$2.25M

INTRODUCTION

(G) Tax-Advantaged history of prior §§ 174 & 1235.

Prior recent PTO obstreperousness patents didn't require heavy investment. Inventor after tax wealth should easily have been many multiples of investment.

INTRODUCTION

(H) Tax Disadvantages of current provisions §§ 174 & 1235.

(1)

The “in connection with” language was written out of § 174.

This, and other provisions stress already being in business.

INTRODUCTION

(H) Tax Disadvantages of current provisions §§ 174 & 1235.

(1) Principles recognized:

Do as much low profile research as possible before starting business.

Entity formation can have cost & obligation elements, so be certain about entity configuration first.

INTRODUCTION

(H) Disadvantages of current provisions §§ 174 & 1235. (1)

Detailed records should name a consistent official day of start, and insurance should be effective on that day.

INTRODUCTION

(H) Disadvantages of current provisions §§ 174 & 1235. (1)

First dollar of revenue should result on startup day to resist an accusation that activities were pre-startup and therefore capitalizable

INTRODUCTION

(H) Disadvantages of current provisions §§ 174 & 1235. (1)

Admittedly §195 has a very limited provision allowing \$10k deduction for startup so long as total startup expenses do not exceed \$60k.

INTRODUCTION

(H) Disadvantages of current provisions §§ 174 & 1235. (1)

So, if startup expenses are \$70k, the startup gets no immediate deduction (assuming it will have something to deduct against). So, any startup expenses above \$10k will be amortized over 180 months.

INTRODUCTION

(H) Disadvantages of current provisions §§ 174 & 1235. (2)

TCJA simply eliminated self-created patents from capital asset status. So, for human inventors, without capital gain status, §1235 automatic holding is neutralized.

INTRODUCTION

(H) Disadvantages of current provisions §§ 174 & 1235. (2)

Note that in a corporate setting, the corporate entity creates the patent and has prior right in it.

As soon as the inventor executes the patent he assigns it to the entity.

INTRODUCTION

(H) Disadvantages of current provisions §§ 174 & 1235. (2)

The fact that §1235 exists in tact, unchanged by TCJA has confused many practitioners that believe that because its still in the code, that it works in an unchanged way. It doesn't.

INTRODUCTION

(H) Disadvantages of current provisions §§ 174 & 1235. (2)

Given all the obfuscatory factors mentioned above, I don't think the instant capital gains provision is coming back.

INTRODUCTION

(I) Copyright Tax Disadvantaged History (1) Pre-2017

Copyright works & registrations traditionally had no basis in the hands of the creator, and generated ordinary income on sale by the creator.

INTRODUCTION

(I) Copyright Tax Disadvantaged History (1) Pre-2017

If the human author is an employee of an entity, the entity is the creator. Copyright rules even allow the entity to be the named author.

INTRODUCTION

(I) Copyright Tax Disadvantaged History (1) Pre-2017

A sole proprietor commissioned to create a copyright work will likely attract both ordinary gain on the copyright sale and self employment tax.

INTRODUCTION

(I) Copyright Tax Disadvantaged History (1) Pre (& Post) 2017

Patents were placed into the same category as Copyright via amendment to §1221(a)(3) and §1231(b)(1)(C). Actually adjacent each other.

INTRODUCTION

(I) Copyright Tax Disadvantaged History (1) Pre (& Post) 2017

Huge exception was added the law in 2005-6 to grant authors of musical compositions capital gain treatment.

INTRODUCTION

(I) Copyright Tax Disadvantaged History (1) Pre (& Post) 2017 IRC § 1221(b)(3) resulted from lobbying of the Nashville Songwriters Association International. This statute section is a lone entry, not closely associated to the general copyright self created rule.

INTRODUCTION

(I) Copyright Tax Disadvantaged History (1) Pre (& Post) 2017

It does seem strange to me that a programmer can author a valuable 20,000 page program & only get ordinary gain, while a music composer can write a half-page jingle & get capital gains, at sale.

INTRODUCTION

(J) Trademark Tax Semiadvantage
Then and now.

(1) Trademark was unchanged.

(2) Unlike patent & copyright,
mere ownership of a trademark has
a liability component.

INTRODUCTION

(J) Trademark Tax Semiadvantage
Then and now.

(3) Trademarks are capital assets.

(4) LLC entity is often used to own
the Trademark & provide liability
barrier & allow capital gains rates.⁷⁷

INTRODUCTION

(J) Trademark Tax Semiadvantage
Then and now.

(5) Trademark can be related to a design patent. If a product is good and has an attractive, stable configuration, its exterior external shape can be protected long term.

INTRODUCTION

(J) Trademark Tax Semiadvantage
Then and now.

Design patent will protect exterior fanciful elements in shape of a useful item, & later (usually after 5+ yrs on the market), apply for a 3-dimensional trademark possible.

INTRODUCTION

(J) Trademark Tax Semiadvantage
Then and now.

(6) Design Patents have a 15 year
(from issuance) life.

(7) Design Patents are obtainable
with less effort than utility patents₈₀

INTRODUCTION

(J) Trademark Tax Semiadvantage
Then and now.

(7) 3-dimensional trademarks are
usually more difficult to obtain.

(8) Design-pat-to-3D- route is for
stable customer identified features₈₁

INTRODUCTION

(K) Canada as a Comparison and a Canary

(1) Canada's system of providing capital gains, and experiment cost deduction was different in form but similar in effect with the U.S. prior to 2017.

INTRODUCTION

(K) Canada as a Comparison and a Canary

(2) Canada did not seem to need to cut back on its rate of new patents.

(3) It may be that an invention project could benefit from Canada₈₃

INTRODUCTION

(K) Canada as a Comparison and a Canary

(4) A project that would not fit with an existing business and needed to generate use deduction Canada did not seem to need to cut back on its rate of new patents.

INTRODUCTION

(L) Tools

(1) Pre-2017 main strategy of segregation of capital gains/ownership from ordinary income/licensing

(2) Delay Sale using Options.

INTRODUCTION

(L) Tools

(3) “Bundle of Sticks” theory- Sale involves giving up substantially all rights. Some individual retained sticks can be illusory, but can be mis-interpreted. Stick: “Pay Me” to insure judicial sale treatment.

INTRODUCTION

(L) Tools

(4) Licensing to provide control to licensee upon paying all periodic money payments for a whole life of a country's patent has traditionally constituted a “sale” under IRS rules. Timing is important.

INTRODUCTION

(L) Tools

(5) Post-2017 may involve separation of the patent application into a separate corporation (NOT an LLC) where such corporation may be later sold to attract capital gains.

INTRODUCTION

(K) Tools

(6) Another strategy might include creating a tax spin-off in which the patent and a separate line of business is formed as an entity & then sold.

INTRODUCTION

(K) Tools

(7) Diversification of entity business function, to limit liability

(8) Corporation Retained Earnings Limits & (expandable for future plans) for multiple corporations.

INTRODUCTION

(K) Tools

(9) Diversification of Entities to disperse ROI related to different entity functions to run lean & force comparative monitoring

INTRODUCTION

(K) Tools

(10) Constantly re-evaluate the business environment & locations (current and future)

INTRODUCTION

(K) Tools

(11) Apply everywhere for Business Credits and evaluate the enticements to relocate/expand. Delay Sale using Options.

INTRODUCTION

(K) Tools

(12) License & Options

(a) License Carrot & Stick

(b) License & Delayed Sale later

INTRODUCTION

(K) Tools

(12) License & Options

(c) Installment Sale

(d) Retirement Plan Ownership of
business

INTRODUCTION

(K) Tools

(12) License & Options

(e) Commercial and IP Insurance
(Defensive & Offensive)

(f) Private (controlled) Insurance

INTRODUCTION

(K) Tools

(12) License & Options

(g) Other Insurance: commercial; indemnification & bonding.

(h) design patent - trademark life cycle.

INTRODUCTION

(K) Tools

(13) State of Residence

(a) Other Insurance: commercial; indemnification & bonding.

(b) design patent - trademark life cycle.

INTRODUCTION

(K) Tools

(13) State of Residence

(c) Entity operation may have employees, Check the HR cost !

(d) Consider state law choice in each transaction;

INTRODUCTION

(K) Tools

(13) State of Residence

(e) Monitor sales into other states carefully; Sales Tax Nexus after Wayfair can result in other nexus.

INTRODUCTION

(K) Tools

(13) State of Residence

(f) Remember lessons of the Hyatt series of cases: Where significant money is involved, a state will go to outrageous lengths to help itself to any money it can access.

INTRODUCTION

(K) Tools

(13) State of Residence

(f) Remember lessons of the Hyatt series of cases: Where significant money is involved, a state will go to outrageous lengths to help itself to any money it can access.

CHANGES TO TAX

Chart at end of section II.

(1) Utility Patent Was:

- (a) Inventor Capital Asset

- (b) Inside/Outside 1235

Is today:

- (a) Not asset in hand of creator

- (b) Find another cap gain route

CHANGES TO TAX

Chart at end of section II.

(2) Design Patent Was:

(a) Inventor Capital Asset

(b) Inside/Outside 1235

Is today:

(a) Not asset in hand of creator

(b) Find another cap gain route

CHANGES TO TAX

Chart at end of section II.

(1)Utility Patent & (2) Design

Patent tax attributes were changed by designation as non-capital by amendment of the exclusion provisions of the Internal Revenue Code (26 U.S.C. §1221(a)(3) and §1231(b)(1)(C))

CHANGES TO TAX

Chart at end of section II.

(3) Trade Secret Was Patent-like:

Exists as early stage patent bridge (every patent generally a pre application trade secret.

Requires additional element for sale treatment: Promising to give up and never share or practice.

CHANGES TO TAX

Chart at end of section II.

(3) Trade Secret Was:

- (a) Inventor Capital Asset

- (b) Not 1235

Is today:

- (a) Not asset in hand of creator

- (b) Find another cap gain route

CHANGES TO TAX

Chart at end of section II.

(4) Copyright is traditionally:

(a) Very Narrow

(b) Drawn to a different expression of possibly a same underlying idea

(c) Loser pays the winner + cost – exception to American Rule₁₀₈

CHANGES TO TAX

Chart at end of section II.

(4) Copyright previously was:

(a) Not Capital Asset in the hands of the creator

(b) Could be asset if bought from a non-related person & held 1 year before sale.

CHANGES TO TAX

Chart at end of section II.

(4) Copyright now is the same.

Exception since 2005-6: (except for a new narrow “portfolio of music” sale.)

CHANGES TO TAX

Chart at end of section II.

(5) Trademark was:

(a) Capital Asset for creators and purchasers.

(b) Long Term Capital Gain if sold after a one-year holding period.

CHANGES TO TAX

Chart at end of section II.

(5) Trademark attributes:

- (c) Liability for owning

- (d) Absent a specific provision, it's a capital asset that doesn't allow depreciation or write-down unless sold.

CHANGES TO TAX

Chart at end of section II.

(5) Trademark attributes:

(e) Money spent defending the trademark may be subject to capitalization if not divested of the trademark or otherwise sold.

(f) 15 year Amortization for a trademark purchased from another

CHANGES TO TAX

Research Tax Credits

- (1) Several paths to calculate
- (2) Similar & compatible to other aspects of “Cost Segregation.”
- (3) Each individual application should be done consistent with other “Cost Segregation” provisions

CHANGES TO TAX

Research Tax Credits

(4) Always check both federal and state (or province) Research Tax Credits to get a composite picture of costs of operations

(5) Always check state & province general incentive tax credits.

Bankruptcy Risk

Licensor / Licensee Principles:

Asset purchase = capitalize & write-off
over useful life

Asset sale = giving up ~100% ownership
rights

Related entity sale: deductions & gains
restricted

Bankruptcy Risk

Licensors / Licensee Principles:

Capital Asset sale: generally 1 year holding period for long-term capital gains treatment

License = mere promise not to sue licensee

License can act as a contract of sale

Bankruptcy Risk

Licensors / Licensee Effects

(1) Long term license is at greater risk of being seized and sold in bankruptcy.

(2) Now less decision between long term license/capital gain vs. short term license/ordinary income.”

Bankruptcy Risk

Licensors / Licensee Effects

(1) Long term license is at greater risk of being seized and sold in bankruptcy.

(2) Now less critical between long term license/capital gain vs. short term license/ordinary income.”

Bankruptcy Risk

Licensors / Licensee Effects

(3) Like any asset, a license can experience gain with the tax coming out of the bankruptcy estate. Low basis license is less likely to generate as much on sale after paying the gain tax.

Bankruptcy Risk

Licensors / Licensee Effects

(4) Even if the license is seized and sold with a resulting tax based reduction of resulting revenue, a disruption of the contract is a breach and gives the non-bankrupt party a right to contract.

Bankruptcy Risk

Complications

- (a) The bankruptcy code defines “intellectual property” to include patents and copyrights, but not trademarks.
- (b) Trademark licensing monies are generally always ordinary income.

Bankruptcy Risk

Complications

(c) 11 U.S.C. § 365(n)(3) & (n)(4) give licensees more rights to keep and hold onto the (non-trademark) IP license that would otherwise be the case for a non-ip contract.

Bankruptcy Risk

Complications

(d) Thus trademark licensees have less rights, which has always seemed a correct outcome since a trademark licensor is supposed to be able to specify the nature and quality of the goods and services, moment-by-moment.

Bankruptcy Risk

Complications

(e) Even more unusual is that when there have been cases where products are subject to both patent and trademark, the bankruptcy court has treated the product as if it were a patent license

Bankruptcy Risk

Complications

(f) Cases often cite legislative history for the proposition that “trademark was supposed to be treated somewhat similar to patent licensees, but congress ‘forgot’.”

Bankruptcy Risk

Complications

(g) It would seem rare that a case will be encountered where a non-debtor licensor would be stopped from assigning / disposing of a license

Bankruptcy Risk

Complications

(h) Trademark is somewhat favorable to be sold with a separate business, rather than technical aspects.

Bankruptcy Risk

Complications

(i) Trademark is almost impossible to license as a sale because owner of the right to control nature and quality of goods is directly responsible and this responsibility is too important to be delegated.

Bankruptcy Risk

Complications

(i)..Ct'd

In addition, due to residual common law rights, care must be taken to transfer all vestiges of ownership to insure sale treatment.

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