INTELLECTUAL PROPERTY TAXATION

PAST & FUTURE

by

Curtis L. Harrington

HARRINGTON & HARRINGTON

P.O. Box 91719
Long Beach, CA 90809-1719
(562) 594-9784, Fax: (562) 594-4414
http:/www.patentax.com E-mail: curt@patentax.com PATENTAX®

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

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II. Personal Introduction & Viewpoint

This outline is written from my viewpoint as a super-heavy Mechanical-capable chemist, MS Chemical Engineer, MS Electrical Engineering Patent Attorney; and as an MBA, LL.M. (Master of Laws) Tax attorney. If this were a song, it would be a dirge. Forces in government have severely weakened the patent system, both technically and financially.

I have delayed writing a comprehensive outline since December 2017 precisely because the topic is painful. Inventing and success is historically known to go hand-in-hand. This idea was imbued into even the least educated Americans, and even those with scant understanding of the details of the mechanism. My goal as I grew up was to emulate the success of the father of Joan Fontaine & Olivia de Havilland and the father of G. Gordon Liddy. These dads were patent attorneys and did very well despite the economic downturns in the first half of the past century.

Further, rather than wealth and retirement, my plan was to work right up until the day I die.

A goal was to be the most technically proficient that I could be, recognizing that the division between disciplines continues to be that mechanical ability is the default, but that chemistry ability enables chemical and mechanical patent drafting, and that electrical ability enables electrical and mechanical patent drafting, but that a deep chemical and electrical capability enables proficiency at drafting all three - chemical, electrical, and mechanical.

I originally studied tax and became a tax attorney to thereby become a better patent attorney. In the 80's, while attending a software IP conference, became interested in the use of tax treatment of IP to enable technical projects to be performed more efficiently using tax rules. That interest ultimately resulted in my attending University of San Diego as a commuter and earning an LL.M. - Tax. After the IRS Enrolled Agent exam and later the tax specialization exam, I spent 10 years with the State Bar of California Legal Specialization Board with five of those ten tax years in service to the tax specialty, with the other five years spent as a member of the main oversight specialization board. I was fortunate to cap each five year segment as chair, first of the Tax Advisory Committee and then as chair of the Board of Legal Specialization (overseeing all specialization disciplines).

So, I was able to utilize a deep technical background in combination with a relatively deep tax education to help inventors to perhaps avoid problems by creating licenses that certainly took advantage of the favorable tax benefits then associated with the various forms of intellectual property. I expected to be in high demand, but the patent system has effectively shut-out my individual inventors and startup businesses. In the current day, an individual or small business should consider that the probability of having a patent issue is SIGNIFICANTLY LOWER than it was ten years ago. It is lower still for computer inventions or narrow improvements over a present day technology.

What I had never counted upon is the possibility that government and forces behind government would begin to deliberately disadvantage the patent system, both technically and financially. No small part of the reasoning behind the conclusion that the patent system might not be helping the country much, (if true) was in no small part due to the actions of China in further lessening the value of control of the American retail market (if true). Other reasons may include (singly or in multi- combination):
1. Innovators are more interested in creating program applications (apps) than stand alone shippable items;
2. Sales Tax Revenue falls and state legislators will always spend more than they collect in tax;
3. Less invention products for export (Apps usually do not help governmental balance of payments in trade)
4. Today’s drop ship, NAFTA/USMCA, porous entry, Just-In-Time & direct shipments to customers cause infringers to be more difficult to identify OR locate.
5. Government believes that a strain on the economy from threat of IP lawsuits is not outweighed by greater rewards for the innovative entity.
6. The reduction in innovation for new products has slowed, and tax benefits provided to individual inventors and their inventions are too costly to government.
7. Patents used by non-producers (often referred to as trolls) were not being used by the patent holder to compete in the market, but to damage otherwise competitive industries.
8. Tax patents formed the “whipping stepchild” of the movement to restrict the patent system.
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.
10.In the past 5 years examiners have adopted a tactic of not engaging arguments directly, & generally “dismissing” applicant’s position without direct engagement.
11. Examiners can gauge a credible threat of appeal and may be less attentive and helpful to individual applicants and their practitioners.
12. Interpartes review
The possibility that even when a patent issues, a post issuance proceedings such as an Inter Partes Review (IPR) which can cost more than an appeal. One source states that 85% of the claims of a patent beginning an IPR receive cancellation. Most IPR proceedings are triggered by the initiation of a patent lawsuit. So, even if the IPR were free it is likely to decimate a patent. Further, an IPR is reported to cost over $100,000.
13. May 22, 2017 interpretation of the district court venue rules that permit venue in a jurisdiction where the defendant does not reside. TC Heartland LLC v. Kraft Foods Group Brands, LLC, 581 U.S. ___.(2017). The 28 U.S.C.§1400(b)

statement of venue as “civil action for patent infringement may be brought in the judicial district where the defendant resides, or where the defendant has committed acts of infringement and has a regular and established place of business.” The court ruled that a corporation “resides” only in its state of incorporation.

IP Category	Pre 12/2017	Post 12/2017
Utility Patents	Inventor Capital Asset Inside/Outside 1235	Not an inventor Capital Asset.
Design Patents	Inventor Capital Asset	Not a Capital Asset
Trade Secret	Capital Asset (related to patent)	Not a Capital Asset
Copyright	Not a Capital Asset In Hands of Creator, but was a Capital asset if purchased from another taxpayer	Not a Capital Asset (except for a new narrow “portfolio of music” sale.)
Trademark	Capital Asset	Capital Asset
(1) Mechanism of Change: Patents and Copyrights were “designated” 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)) (2) Sunset: No		

Note Design Patent crossover with Trademark

III. Overview of Technical Intellectual Property Negativity & Categories

A. COPYRIGHT

1. Copyright, like all other forms of intellectual property, is based on negative rights. A copyright registrant may **exclude others** from reproducing a given copyrighted work, composing a derivative work, performing the work publicly, distributing the work (including sale, lease, or rental of the work), or displaying the work. Works that may be protected by copyright include literary works; musical works and accompanying words; audiovisual works, including motion pictures; sculptural works; pictorial, graphic and architectural works; sound recordings; and, pantomimes and audiovisual works.

2. The power of copyright is especially effective in preventing the rote copying of a work. A work is a fixed, complete form of authorship. To be complete, a work must have all of its component parts. A computer program which does not run and has no utility is a good example of an incomplete project that is not a work. Direct copying is the easiest form of copyright infringement activity to prevent. However, the test in copyright is one of substantial similarity. Whether a copied work is substantially similar to the copyrighted work is a question of fact to be decided by a jury.

3. Rights conferred to a copyright registrant can be retained or licensed as the copyright registrant sees fit. For example, a license agreement may be crafted based on the registrant’s rights. License agreements can be as broad and open as any contract and can require a licensee to pay money or perform other duties in exchange for the license. The ability to exclusively perform the work is especially important for playwrights who receive royalties, not only from the publication of their plays, but also from the performance of their plays.

4. Certain areas of copyright law are rife with traps for the unwary copyright registrant. First, a work must rise to a minimum level of originality to be considered copyrightable. For example, data works such as columns of raw information may be so lacking in authorship as to be considered unregistrable. Similarly, designs which only include basic geometric forms may also be held unoriginal. Generally speaking, the more complex a work is, the more likely it is to be considered original in terms of authorship.

5. Another area of copyright that may present problems is that of works for hire. Works for hire include works done as a non-contract employee and contributions to a larger collective work, such as a movie. Where a party pays to have a work performed but neglects to clearly specify who the owner of the completed work will be, problems are certain to arise. We strongly advise that those seeking to hire authors, designers, and the like, should not only contract for the work to be done, but should ensure that the contract explicitly sets forth who the owner of the completed work will be. Collective works present another set of problems because all contributing authors must give their permission for use of their constituent parts. The creativity which is applied to organize the parts making up the whole is also protectible by copyright.

6. Joint works also create potential problems for copyright registrants. If a work is prepared by two or more authors who intend to merge their contribution into an inseparable whole, the US Copyright Office will treat each of the authors as having equal rights to register and enforce the copyright, and this holds true whether or not there are other agreements to the contrary between the registrants.

7. The duration of a copyright varies depending on the type of work for which protection is sought. In general, a work is protected for the life of the author plus 70 years (Sony Bono Copyright Term Extension Act). The exceptions to the rule include works for hire, anonymous works, and pseudo anonymous works, which are protected for 95 years from the first publication or 120 years from the year of creation.

8. Copyright notice can be communicated in a number of different ways. The most common forms of notice include the "circle C" symbol or the word "copyright" in full or abbreviated form, as well as the first year of publication and name of the copyright registrant. After March 1, 1989, lack of copyright notice is not fatal, but including a copyright notice is advisable because (1) it lets others know that a work is protected by copyright, (2) it directs would-be users to the copyright registrant for permission to use the work, and (3) it precludes a defendant in a copyright infringement case from using the defense of "innocent infringer" because it serves as constructive notice of copyright, i.e., the defendant is considered to be aware of the copyright whether or not he actually saw the notice.

B. TRADEMARK

1. A trademark is any word, name, symbol, device, or any combination thereof which is used in connection with goods or services to help consumers identify the source of those goods and services for the purpose of differentiating the goods and services from those of competitors.

2. Trademark rights accrue as to a given set of goods or services based upon the theory that successful name recognition will follow increasing quality and excellence. Trademark rights begin with the use of the trademark. For this reason, later users of a trademark can potentially be foreclosed from using a name. The scope of rights in a trademark depends upon how the mark is used. For example, the trademark EXXON is generally thought to be a coined mark, such that it would preclude any use by others, even where the use might be for non-petroleum goods and services. The scope of rights for other, lesser-known trademarks, is usually narrower than the

scope of rights for coined marks, such that the use of the mark in one area will generally not prevent the use of the mark in other goods and service areas.

3. Use of a trademark is demonstrated with specimens that show how the mark is used with the goods. The best way to show trademark usage may be to impress the trademark directly upon the goods. Tags and labels applied to the goods are another proper way to use the trademark. However, it must be kept in mind that a use which is too greatly removed from a direct association with the goods may fail as a proper use.

4. Because there are no "goods" upon which to affix a service mark, an advertisement is generally the only way to show a connection between a service mark and the services to be associated with the mark. Aside from the differences in which the use is shown, the application and examination procedure is approximately the same.

5. Note that there are two basic mechanisms for naming a business which have nothing to do with trademarks. The county designation "doing business as," or DBA, and the state corporate filing are both employed to insure that there will be a responsible entity doing business in the county or state, and that the responsible entity is distinguishable from other entities. These designations help to be sure that no two entities have the same name either locally or on a statewide level.

6. Therefore, the steps necessary for acquiring a federally registered trademark are generally as follows:
   (a) Select the mark using the following guidelines:
      % Pick a word that is NOT in a dictionary (of any language, but especially English);
      % Pick a word that is NOT similar to any trademark word of someone else;
      % Pick an UNUSUAL, DISTINCTIVE word;
      % Pick a word that is NOT a person’s last name;
      % Pick a word that is NOT descriptive (IN ANY WAY WHATSOEVER) of the goods or services which will be associated with the trademark or service mark. (Note: The PTO is strict on this point, and even if you get a mark with descriptive aspects past the PTO, a descriptive mark is likely to cost you precious, hard-earned profits in the long run);
      % Pick a word that does NOT end/conclude with a descriptive noun;
      % Pick a word that excludes all descriptive words;
      % Pick a word that is not geographic; and.
   . % Pick a word that is not scandalous, vulgar, derogatory, etc.

   (b) Use the mark properly in interstate commerce (generally in public business)

   (c) Apply for federal registration of the mark
      % PTO may examine the application in about 1 year
      % PTO will publish the potential mark to give an opportunity for members of the public to oppose registration of the mark
      % Registration of the mark will occur in approximately 6 months after publication, assuming no opposition was filed or, if an opposition was filed, assuming it was not successful
      % First renewal is due after 5 years continuous use (§8)
      % The mark becomes incontestable after 5 years of use (§15)
      % Duration of the trademark protection (i.e., actual ownership) extends for 10 years after first renewal
      % These selection rules dominate the tax treatment in future years.

7. In the tax section of this outline, it can be seen that the above selection rules can be critical in

having a successful outcome for trademark.

8. As you can see, from the first use, incontestability can be achieved in about 6 years from application (assuming no problems during the application process. Many things can stop the process, including a rejection by the Examiner, an opposition filed by another who believes he will be damaged by your registration, a petition to cancel the registration from others, and worst of all, forgetting about the trademark and allowing it to lapse by failure to file the §8 & §15 affidavit.

9. One possible way to think about trademark in the U.S., as a general construct, and will bend the mind of anyone who believes that trademarks are like some sort of "permit" that you purchase and keep forever, is the boiling down of trademark, if it were possible, which it is not truly possible, but which might be imaged as involving but two rules:
   Rule 1: First substantial federal user wins;
   Rule 2: A trademark owner who obtains registration + 5 years of usage, cuts off the priority rights of a trademark owner of Rule 1. (incontestibility)
   The trademark system is more complicated than this, as it includes matters of trade dress, palming off, special rules on sourcing of geographic products of origin, etc., but thinking this way will aid in realization that the most important ownership event in the life of a regular trademark is the achievement of incontestibility.

10. There is no stated "positive right" to select a mark, and trademark infringement suit is an action to EXCLUDE someone or some entity that has lesser rights. Those lesser rights can be common law, state rights, secondary register, rose-tea doctrine rights, as well as many rights and loopholes found elsewhere, but especially in agreements related to licenses, agency, distribution rights, & supply source requirements and more.

C. TRADE SECRET

1. A trade secret is considered to be any information (including a formula, pattern, compilation, program, device, method, technique or process) which (1) derives independent economic value (actual or potential) from not being generally known to the public or to other persons who could obtain economic value from its disclosure or use; and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

2. It is illegal to acquire a trade secret of another where the acquiring person knows or has reason to know that the trade secret was obtained by improper means. Improper means include theft, bribery, misrepresentation, breach or inducement of breach of a duty to maintain secrecy, or espionage through electronic or other means. Reverse engineering or independent derivation alone is generally not considered improper means. There is also a companion definition in the penal code which makes trade secret theft a felony.

3. Whether a trade secret has been truly protected is not merely a question of whether it was kept secret; the systematic steps and procedures taken to keep it secret are crucial to the determination of protection. Evidence of locking doors, assigning keys, and segregating personnel based on a need to know will be dispositive in determining whether one has acted to protect secret a trade secret.

4. This area of law cuts a fine distinction where control of people is concerned. One's ability to use the knowledge gained from an employer is distinguishable from one's right to use one's skills and knowledge, apart from the specifics of the trade secret, in a specialized area. These factors are carefully weighed by the courts, especially where the secret is related to the specialized area of knowledge.

5. Generally, patents start out as trade secrets between the time that they are formulated and until they are written up and filed as a patent application. As will be seen, the tax treatment of trade secrets can, depending upon how it is structured, be equivalent to patents with a further adjustment of surrender of further rights to create a sale.

D. PATENT

1. There are generally three kinds of patents: design, plant, and utility. Design patents protect the way something looks, e.g., the look of an automobile, a computer, a pair of tennis shoes, or a vacuum cleaner. Plant patents protect varieties of plants such as orchids, roses, flowers, and other agricultural plants. Utility patents provide protection for things and the way they work, e.g., circuits, machines, chemicals, and processes.

2. Patentable subject matter includes machines, processes, compositions of matter, articles of manufacture, software and computer processes.

3. Two common categories into which utility patents fall are (1) process and apparatus for practicing a process, and (2) compositions of matter and processes involving compositions of matter. A new, unexpected use for an old, known composition of matter can qualify for a patent. An apparatus and process steps for use of the apparatus are generally intertwined; therefore, new uses for an old machine are rarely patentable.

4. Traditionally, the copyrighting of software was an accident resulting from a characterization of the early programming as language rather than machine setting. As a result, computer programs began under the characterization of language composition and thus copyright. Eventually software came be seen as dual recognition matter, with copyright protecting the style of program writing and patent protecting a programmed machine step. Even as the Supreme Court spoke through the Bilski case there is still no concrete direction, except that Congress just dumped tax patents which were no threat anyway. After Bilski, the PTO still wants to see machine steps and its not exactly clearly the extent to which business method patent are going to be allowed.

5. Software patentability has undergone a change over the past decade.

   (a) In State Street Bank & Trust v. Signature Financial Group, Inc., 149 F.3d 1368 (Fed. Cir. 1998), the U.S. Court of Appeals for the Federal Circuit (CAFC) held that (1) ALL software is patentable and (2) business methods are patentable. The rule that methods of doing business were not patentable had been in force for 100 years prior to this decision. This ruling has been accepted by the US Patent Office, and has been validated and expanded in subsequent rulings of the CAFC.

   (b) A case which has limited the patentability of some computer software has been decided by U.S. Supreme Court. Bilski v. Kappos 561 U.S. 8 (2010) held that the machine or transformation test is not the sole test for patent-eligible subject matter. Another case, Alice Corp. V. CLS Bank International, 573 U.S. 208 (2014) both further limited software cases, but more importantly called into question the legitimacy of all then-current patented software inventions. "Abstract ideas" as implemented on a computer probably may not be enough to form a new machine absent a compelling argument.

   (c) A combination of the ire raised against tax patents as a form of business method patent (having gone too far) has prompted, (catalyzed) and perhaps caused the timing of the change in the law from "first to invent" to "first to file" under the American Inventor's Act which was implemented in September 2012 and March 2013. The legislation provided for an "overseer anti-business patent board" politely named a "Transitional

Program for Covered Business Method Patents" The AIA specifies that a covered business method patent is a patent that claims a method or corresponding apparatus for performing data processing or other operations used in the practice, administration, or management of a financial product or service, except that the term does not include patents for technological inventions.

(d) With the biological arts the controversy over what is patentable leads to some newly articulated "laws of nature" language. In Mayo Collaborative Services. v. Prometheus Labs. Inc., 566 U.S. 66 (2012), the U.S. Supreme court opined that "if a law of nature is not patentable, then neither is a process reciting a law of nature, unless that process has additional features that provide practical assurance that the process is more than a drafting effort designed to monopolize the law of nature itself."

(e) It is believed that the changes in the patent law since 1999 have resulted from a wish "not to be left behind" from the changes in the patent law of Europe & Japan, yet alternatively trying to "rein-in" the outlandish problems that might result from a liberal interpretation of what may be patentable. The U.S. does not want the world to get ahead of it, but takes pains to try and trim the excess that might (and has) been brought along with such liberalization. Tax patents are an area in which I have written that they posed no danger and are not practically enforceable due to (1) confidentiality of tax returns, (2) the ability for the IRS to "outlaw" any procedures it didn't agree with, and (3) the very negative association of anyone in the tax field who owned such patents with the IRS and Tax court, as well as the fear among clients of such patent owners that they would be singled out for audit. Put another way, having your taxes done by a licensee under the patent "marks" you for audit should the tax principles of the patent owner be found to be illegal or later held to be invalid. From the client's perspective, why let yourself be ranked in the IRS's patent technique audit categories?

(f) As a matter of interest, note that on August 28, 2013 that the nation of New Zealand banned software patents. New Zealand doesn't want its people to be stopped or reluctant in any way from their "coding" activities.

6. The following results have gradually grown out of the State Street Bank decision:

(a) The public policy blunder of having previously placed software under the tax-disadvantaged copyright protection domain is somewhat remedied by a substantial removal of software from the tax-disadvantaged categories. Consequently, software which embodies (novel and non-obvious) business methods, even if the business methods are suspect and subject to attack by the "Covered Business Method Patents" board, the tax benefits will likely not suffer much due to the time it takes for eventual holdings of patentable subject matter / nonpatentable subject matter and the lesser patentable / nonpatentable standard.

(b) Instant capital gains (were, prior to 2017) still theoretically available for software creators under IRC §1235 if the software had a "chance" at patentability, and the IRS never had the wherewithal to divine what is "potentially patentable" from what is "not potentially patentable".

(c) Most software development might have previously been expensed under IRC §174 as research. (BUT IRC §174 changed after 2017)

(d) Prior to 2017, sale of both patents and trade secrets resulted in instant capital gains under IRC §1235 for both creators and those in privity with creators before the invention is proven. Likewise, both patents and trade secrets had allowed for expensing and capitalization under IRC §174 for costs of creation and patenting activities.

(e) Generally, before 2017, copyrighted material and associated software receive the most tax-disadvantaged treatment, including denial of capital asset status to creators, non-deductibility of creation costs, ordinary income on sale by the creator, and only regular capital gains on resale once the asset leaves the purchaser's hands. After 2017 a provision was added to enable "music composition portfolios" available for capital gains IRC §1223, really turning copyright tax treatment for self-created works on its head in this one, narrow area.

. Effect of Dependence on Prior Law (Pre-2017)

(a) (Pre-2017) Software and other works which have traditionally been considered "copyright-like" receive the following tax treatment: (1) such works are not capital assets in the hands of the creator; (2) development costs for such works may not be capitalized by the creator; (3) development costs for such works have previously not been expensible by non-creator payors (though this is not the case currently); (4) such works have a longer write-off period based upon the life of the author plus 70 years for general copyright, with some shorter write-off exceptions specific to software. As a result of these factors, and depending upon the type of business in which a taxpayer is engaged money earned will be ordinary income in any event.

(b) (Pre-2017) Individual software creators/inventors are much more keenly affected by the ability to claim patent rights since the patent protection is much more powerful and tax-favored. Some of the commentators from the 1990s have commented that merely seeking copyright protection can result in the less favorable copyright-like tax treatment. There are some copyright deduction rules for off-the-shelf software, but immediate expensing under the patent tax rules are still preferable. Electing to capitalize a patent may only be logical where there is a net operating loss carry-forward that would be lost if one elected to expense the patent.

(c) (Pre-2017) Expansion of the current controversy has continued along the same lines as the controversy between design patents and 3-D copyrights. The regulations take the view that if property is only protected under the patent laws, IRC § 1221(3) denying asset status will not apply. Gilson v. Commissioner states that if the taxpayer is not utilizing copyright laws, he should not be subject to harsher tax treatment. In the software area, the degree of dual protection is even greater, since patent protects a method, and a software copyright protects only the expression of the process in a specified language. However, licenses should be carefully drawn to distinguish these rights. This differs from the design and 3-D copyright dichotomy, where there is a bright line separation between the two areas based upon whether the item is utilitarian in nature.

(d) (Pre-2017) As set forth below, the ability to write off development of software along the same lines as patent is was then available. Tax treatment for sale of copyright remains grossly different from tax treatment for sale of patent by two primary factors: (1) sale of copyright by a creator results in ordinary income because a copyrighted work is not a capital asset, and (2) the waiting period for capital gains treatment on sale of copyright is one year, even where an individual purchases a copyright and can thus hold it as a capital asset. (In essence an owner needed a purchase value to create a basis and then hold the asset for more than a year).

(e) (Pre-2017), Another pre-Alice case, AT&T Corp. v. Excel Communications Inc., 98-

1338 CAFC, has even further extended the patentability of software rule. Generally, this case stated that, so long as an algorithm is not usurped and so long as the claims are drawn to the algorithm in a USEFUL way, the algorithm may be patented. This change in classification of software was decimated by Alice.

(f) There may be some confusion about the statement that "all software is now patentable", as this statement merely means that all software is within the §101 definition of patentable subject matter. Thus, it is implied that perhaps only a small portion of software may actually be patentable. This may not matter from either a practical or a tax standpoint. To wit, you will recall that patents and trade secrets are treated the same from a tax perspective; we believe the reason for this could be that the taxing authority was not interested in waiting years to determine whether an item was patentable. Additionally, an idea which is patentable is technically a trade secret until it is publicly disclosed. Because software is now treated no differently than other patentable matter, there is also no barrier to treating software as a trade secret.

(g) For example: A software program in 2013 is very similar to one which was patented and published in 2012, i.e., it differs only by a few kinks and twists which are clearly trade secrets, but which do not rise to a level beyond the obviousness threshold. This software is a trade secret and is given the same benefits as if it were a patentable trade secret. Both the patentable and unpatentable versions of the software may be sold as trade secrets with corresponding capital asset treatment and instant capital gains under IRC §1235. Both may be the subject of a patent application (after all, the obviousness issue must be addressed by the examiner, and if the examiner rejects the claims in the final analysis, this may not occur until years later). Patent applications for both the patentable and unpatentable versions of the software may be the subject of an assignment within the Patent Office to show title, and either version may be the subject of an appeals process where there is a holding of non-patentability. Further, both applications may be the subject of later continuation-in-part applications which may include added details that result in patent issuance.

(h) In summation, ultimate patentability based upon how good the invention is has never had anything to do with tax treatment. Conversely, the classification of subject matter as patentable or non-patentable has been crucial to tax treatment. For this reason, the mischaracterization of machine steps as copyrightable has always been problematic. With software patent and trade secrets looming on the horizon, we can only hope that the IRS stands ready with an intelligent position to avoid clogging the courts.

8. Patent Enforcement: Making the System Work

(a) There are multiple considerations for the patentee who finds it necessary to actively enforce patent rights. Careful thought must be given to setting the tone of negotiations or licensing; crafting the notice of infringement; laches and estoppel; applying and maintaining pressure on infringers; International Trade Commission (ITC) actions for imports; marshaling infringers to finance the action; and, acquiring patent insurance to cover suits against infringers as well as to insure against the possibility that a patent may be invalidated. It is of note that there are few companies which provide offensive patent insurance that may be used to pursue infringers. Intellectual Property Insurances Services Corporation has recently made available a policy for the loss of intellectual property value, and they may be contacted by mail at Suite 114, 10503 Timberwood Circle, Louisville, Kentucky 40223; by phone at 1-800-537-7863; or by e-mail at info@infringeins.com.

(b) Value may be extracted from an issued patent by either (1) running a manufacturing operation as a monopoly, or (2) licensing other manufacturers to make the patented product. An exclusive license is a permission granted to a single manufacturer. A non-exclusive license may be granted to one or more manufacturers. The central difference between an exclusive and a non-exclusive license may lie in what actions are contractually assumed in the license if the patent is infringed. It is much more likely that an exclusive licensee will undertake to sue to protect the patent. Where there are non-exclusive licensees, the patent owner will generally be the one to undertake suit to protect the patent.

(c) Patent holders who find themselves in the unfortunate position of accused infringer also have multiple considerations. Intensive investigation and careful planning should ensue immediately: defensive insurance status should be determined; an opinion on patentability should be acquired; economic analysis should be performed as a prelude to potential licensing agreements; data on other potential infringers should be gathered; information damaging to the patent should be documented; and, a re-examination request may be in order where there is sufficient printed matter to support it.

IV. Tax Research Credits

1. (Pre-2017) IRC §174(a) allowed research or experimental expenditures to be treated as deductible expenses if they (1) are paid or incurred by a taxpayer during the taxable year, and (2) are in connection with the taxpayer's trade or business. The term "**in connection with**" was present pre-2017 & was deliberately less stringent than the "ongoing business concern"

2. Its now clear that (post-2017) that being "in business" is necessary for research deductions, including (1) IRC §162 which allows deductibility only for (1) ordinary & necessary expenses which are (2) paid or incurred in carrying on a trade or business. This would seem to indicate that a presently functioning business is a precondition of deductibility under IRC §162. In addition, (Pre & Post-2017) IRC §41 gave/gives taxpayers, typically large corporate taxpayers, a credit based upon either (a) a regular credit for qualified research expenditures which exceed some fixed base percentage of average annual gross receipts or (b) an incremental credit based upon current qualified research expenditures which exceed research intensity for a given base period. Although a percentage popularly stated with respect to this credit is "20%" there are other limitations to both credits which reduce the 20% value to a much lower figure. IRC §41 was amended in 2017 with some provisions to begin after 12/31/2021.

3. The main consideration for IRC §41 is that it has more than one route to computation. In fact, it may be that IRC §41 is best applied as one member of a suite of "cost segregation." This may be especially so given the general requirement to be "in business" and the fact that cost segregation's goal is the acceleration of expensing for entities "in business" The ability to obtain more benefit from one path of computation over another will likely depend upon other paths of deduction that may compete with the IRC §41 deduction (along with its computation method). A totality of circumstances should be considered in comprehensive approach to cost segregation, of which IRC §41 will form a part.

4. State research and cost segregation credits should be considered along with federal computations. For example, California has a credit similar to the Federal Credit in structure, but only for research conducted within the state of California. Revenue & Tax Code §17052.12 (Personal Income Tax) and Revenue & Tax Code §23609 (Corporate Income Tax).

5. Compare Canada's Scientific Research and Experimental Defelopment (SR&ED) program.

Canadian Federal 35% for the first $3,000,000 invested per year (and 15% of amounts over $3,000,000 - of which 40% of this credit may be refundable) for research by Canadian Controlled Private Corporations (Internal Revenue Act §127(10.1)). This Canadian federal benefit is supplied along with supporting refundable tax credits from the provinces (except for PEI, Nunavut, & Northwest Territories). Past examples have included Ontario (8% refundable and 3.5% non-refundable); British Columbia (10%); Manitoba (20%); New Brunswick (15%); Newfoundland and Labrador (15%); Nova Scotia (15%) ; Quebec (was 30% seems now to be 14% to 16%); Saskatchewan (10%); Yukon Territory (15%). These provisions seem to change year by year. Anyone considering research in Canada should check each province & location, and give due consideration to the corporate form and country of ownership of the entity.

6. The general trend these days is toward "Cost Segregation" a technique in which each element of expense is analyzed to see if it can fit into a credit category. Firms such as KBKG operate web sites offering free CPE to accountants and other tax professionals to educate them about the technique. Expenses, if properly segregated, can result in a benefit which goes beyond the benefit of a mere deduction. In some cases a deduction may fit into several tax credit categories. Several firms have arisen making money by offering the service of optimizing a firms tax credit categories.

V. Bankruptcy Risk

1. Generally:

Prior to 2017, when the possibility of instant capital gain treatment was available, the licensor had to license (1) the whole Patent, for (2) the whole geographic country from which the patent issued, for (3) the whole term of the patent. Whole term required that the licensee have the ability to exclusive control of the patent provided they only hinged that right upon money.

The problem with this arrangement is that it allows and encourages a bankruptcy trustee to take control of the property. A person cannot write a "if there is a bankruptcy" different term into a license as the bankruptcy court would ignore it. The bankruptcy code favors that which will maximize the value of the debtor's estate and, even if it means allowing the trustee to assign notwithstanding a provision in the patent license. In re Rickel Home Centers, Inc., 209 E3d 291,299 (3d Cir. 2000). This principle of federal assignability in bankruptcy of that which could not be assigned outside of bankruptcy can most directly harm non-debtor licensors. Profit maximization of licensor-debtors may tend to generally increase the price of doing business for non-debtor licensees. Generally, non-exclusive licenses should not be assignable in bankruptcy without the licensor's consent, but case law exists on both sides of this question.

Therefore it can be readily seen that a licensor was forced to choose between a favorable capital gain rate by providing words in the license that gave the licensee control, or alternatively an unfavorable ordinary income rate where the licensor provided less control rights in a licensee such that the license is then treated as "not-a-sale."

Insofar as a bankruptcy trustee is concerned, any license period that makes the license worth selling (after the license is accepted by the estate trustee) is dangerous. A monthly, or month-by-month license that is completely discretionary and requires some form of written renewal every month is the sort of license that might otherwise become lapsed by the time the trustee evaluates the bankrupt estate. However, now that patent inventor licensor income is likely to only be ordinary income, there might be nothing lost from setting the license renew/continue period at a month or two, so that if bankruptcy occurs, the license might be allowed to lapse by the licensor. Likewise, a money payment from a licensee set to occur monthly might enable the license to lapse on non-payment of royalty. Note however that the assent mechanism must not be automatic and must be at risk of forfeiture during each period. Superb records must be kept. If the trustee holds that a series of short licenses were not actually administered in that way and that the underlying license was defacto a longer duration license, this technique might not work.

2. Licensee Bankruptcy Generally:
A licensee may be able to keep using the technology if the debtor-licensee elects to retain the license rather than reject it, and especially where the licensor does not object. The licensor may or may not be able to receive full compensation where the debtor-licensee was in arrears pre-petition. Another factor may relate to whether the licensor can maintain control of the nature and quality of goods and services licensed inside a bankruptcy as well as outside of the bankruptcy. Another factor may be whether the license was more akin to more permanent licensee ownership and thus the ability to hold the license may be strengthened (for example, where standards setting is limited, or where there is some shared responsibility for control in the license).

Licensee rejection of the license may create damages in the licensor, much of which may be difficult to prove or which may be compensable for pennies on the dollar as prepetition debts, as rejection is deemed to have occurred a moment before the bankruptcy petition was filed. Thus, it may be that in a majority of instances, the licensor simply files a bankruptcy claim and that may be the end of it. Mounting an adversary proceeding in bankruptcy court to attempt to prove special damages caused by a licensee may not make much economic sense.

3. Licensor Bankruptcy Generally: (11 U.S.C. § 365)
Licensor bankruptcy presents a possibility for (a) acceptance of the license contract (with all of its attendant responsibilities), (b) rejection of the licenses and then dealing with the technology in house (reunifying the monopoly), or (c) rejecting the lower performing licenses and accepting higher performing licenses.

Similarly, licensees that have licenses rejected by the licensor-debtor may (1) file a claim against the estate along with the other creditors or (2) elect to retain its rights under the contract as they existed at the time of bankruptcy filing (along with the obligation to continue paying under the license agreement, and waive right to setoff damages).

Limited to Old Technology: It is emphasized that the progression of technology for involuntary licensing under 11 U.S.C. § 365(n)(3) & (n)(4) contemplates technology limited to the state in which it had progressed up to the date of bankruptcy filing, and usually not later or ongoing developments.

4. 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.
(c) 11 U.S.C. § 365(n)(3) & (n)(4) give licensees more rights to keep and hold onto the license that would otherwise be the case for a non-ip contract.
(d) The result is that 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.
(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.
(f) Cases often cite legislative history for the proposition that “trademark was supposed to be treated somewhat similar to patent licensees, but congress ‘forgot’.”
(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. This is possibly because:
(1) a naked trademark assignment would constitute an abandonment of the trademark (not

a bankruptcy-type abandonment, but a complete abandonment as to the world),
(2) there is flexibility for a licensor to perform a corporate reorganization to split lines of business into separate businesses with independent, nonbankruptcy right to do so, followed by the sale of the spin-off entity,
(3) The trademark owners has rights under Trademark Manual of Examining Procedure (TMEP) § 1615.01 to divide the registration and which does not appear to be limited by the trademark class, but rather ownership of goods and services (but note that the requirement of change of ownership before division creates a "chicken and egg" limitation where pre-event planning may be slightly constrained), and
(4) There is the inherent flexibility for the owner of the trademark, the controller of the nature and quality of goods to morph his set of trademark words and symbols over time to control the depth, shape, and extent of his trademarks, and thus any license to which the trademark owner was bound could be caused to diminish, while the trademark owner brings up and strengthens the value of other trademarks which are not licensed to the debtor licensee over time.

(h) Trademark is somewhat favorable to be sold with a separate business
(i) Trademark is almost impossible to license as a sale because nature and quality of goods owner is directly responsible and this responsibility is too important to be delegated.

5. TAX TREATMENT OF LICENSE INCOME AND EXPENSES DURING BANKRUPTCY

Generally taxes must be filed during bankruptcy. Debtors filing under chapters 7, 11, 12, and 13 of the Bankruptcy Code must file all applicable federal, state, and local tax returns that become due after a case commences. §346 (k)(1) & (2). Failure to file tax returns timely or obtain an extension can cause a bankruptcy petition to be converted to another chapter or dismissed.

Creation of the Bankruptcy Estate. The filing of a bankruptcy petition creates the bankruptcy estate. The bankruptcy estate consists of property that belongs to the debtor as of the filing date. The bankruptcy estate property is used to pay the debtor's creditors.

Separately taxable estate for Chapter 7 and 11. The chapter 11 and 7 estates are the taxable entities for postpetition income 26 U.S.C §1398(e) & 11 U.S.C. §346(a).

Non-separately taxable estate for Chapter 12 and 13. Chapter The bankruptcy estate is not treated as a separate entity for tax purposes when an individual files a petition under chapter 12 (Adjustment of Debts of a Family Farmer or Fisherman with Regular Annual Income) or 13 (Adjustment of Debts of an Individual with Regular Income)§1398(e) of the Bankruptcy Code. The individual should continue to file the same federal income tax returns that were filed prior to the bankruptcy petition. Chapter 13 reorganizations are not available to corporations or partnerships and are only available to individuals.

Separately taxable bankruptcy estates are also separate for state & local tax. Whenever the Internal Revenue Code of 1986 provides that a separate taxable estate or entity is created in a case concerning a debtor under this title, and the income, gain, loss, deductions, and credits of such estate shall be taxed to or claimed by the estate, a separate taxable estate is also created for purposes of any State and local law imposing a tax on or measured by income and such income, gain, loss, deductions, and credits shall be taxed to or claimed by the estate and may not be taxed to or claimed by the debtor. 11 U.S.C. §346(a)

Where there is no separate taxable estate, debtor is responsible, but trustee must report locally. Whenever the Internal Revenue Code of 1986 provides that no separate taxable estate shall be created in a case concerning a debtor under this title, and the income, gain, loss, deductions, and credits of an estate shall be taxed to or claimed by the debtor, such income, gain, loss, deductions, and credits shall be taxed to or claimed by the debtor under a State or local law imposing a tax on or measured by income and may not be taxed to or claimed by the estate. The trustee shall make such tax returns of income of corporations and of partnerships as are required under any State or local law, but with respect to partnerships, shall make such returns only to the extent such returns are also required to be made under such Code. The estate shall be liable for any tax imposed on such corporation or partnership, but not for any tax imposed on partners or members. 11 U.S.C. §346(b)

Transfers between the bankruptcy estates (into the bankruptcy estate at the start of a case, and out of the bankruptcy estate at the end of a case) is normally a non-taxable event. For purposes of any State or local law imposing a tax on or measured by income, a transfer of property from the debtor to the estate or from the estate to the debtor shall not be treated as a disposition for purposes of any provision assigning tax consequences to a disposition, except to the extent that such transfer is treated as a disposition under the Internal Revenue Code of 1986. 11 U.S.C. §346(f).

Estate to Use Taxpayers Accounting Method. The estate in any case described in subsection (a)[bankruptcy created separate taxable estate] shall use the same accounting method as the debtor used immediately before the commencement of the case, if such method of accounting complies with applicable nonbankruptcy tax law. 11 U.S.C. §346(e)

26 U.S.C §108 debt forgiveness income is inoperable by virtue of 11 U.S.C. §346(f).

Rate of interest on tax claims generally. If any provision of this title requires the payment of interest on a tax claim or on an administrative expense tax, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate determined under applicable nonbankruptcy law. In the case of taxes paid under a confirmed plan under this title, the rate of interest shall be determined as of the calendar month in which the plan is confirmed. 11 U.S.C. §501(e)

Married debtors on a joint bankruptcy each create a separate estate that must be treated as two separate entities for tax purposes even if both estates are jointly administered.

Note that for Intellectual Property of a low basis, but high sale value, taxes must be paid on the gain, before money is available for the creditors. An analysis of low-basis assets should be performed to see if the IP is worth attempted sale by the trustee, or whether there is basis to ask the trustee to abandon the IP assets because they might not have any net benefit to the estate.

Contact: **HARRINGTON & HARRINGTON - PATENTAX®**
P.O. Box No. 91719, Long Beach, CA 90809-1719 patentax.com
Tel. (562) 594-9784; Fax (562) 594-4414 curt@patentax.com

Specialty: High Technology Patent / Trademark / Intellectual Property Law & Taxation

Education:
B.S. Chemistry - Auburn University (1974)
M.S. Electrical Engineering - California State University Long Beach (1990)
M.S. Chemical Engineering - Georgia Institute of Technology (1977)
J.D. - University of Houston School of Law (1983)
M.B.A. - University of Oklahoma (1985)
LL.M. *Taxation* - University of San Diego School of Law (1997)

Admitted to Practice:
Supreme Courts of California, Arizona, Texas, & Nevada
U.S. Supreme Court; U.S. District Court, C.D. - CA & S.D. - TX
Internal Revenue Service U.S. Patent and Trademark Office
U.S. Court of Appeals for the Federal, Fifth & Ninth Circuits
California Dept. of Real Estate - Broker; Los Angeles County CA EMT-Basic
U.S. Tax Court FCC-Commercial & Amateur Extra
Certified by The State Bar of California Board of Legal Specialization: Taxation

Languages Japanese Language Proficiency Exam, (Japan Foundation), Level 4; Kanji Proficiency Exam (Kanji Aptitude Testing Foundation) Level 7, recognized by Japan Ministry of Education, mastery of 640 kanji; Russian reading ability.

Patents Issued Prepared & prosecuted patents, in electrical, chemical & mechanical technologies technical specialty: optics, fiber optics, cryogenics, electromagnetics, & computers.

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, Texas, Arizona & Nevada; California Lawyer's Association (Business & Tax Sections) Central District Consumer Bankruptcy Attorneys Association (2011-Pres); Texas Bar College (2018-pres); & Fellow, National Tax Practice Institute. **Past Member**: Member (2006-2016) of California State Bar Board of Legal Specialization, including Taxation Advisory Committee Chair (2010-11) and Chair of the California State Bar Board of Legal Specialization; Southern California Bankruptcy Inn of Court (2011-2012); Long Beach Bar Assn.(Bd. of Governors, 1994-95); Orange County Bar Association, (Co-Chair Technology Law Section 1996); CA Society of Enrolled Agents (Orange Co. Chapter President 2003-2004); Registered Parliamentarian - National Association of Parliamentarians; Sema Business Management Committee (1997-98); CEB committee (1999-2000); Taxation Section Executive Committee (2002-2005); Income & Other Tax subcommittee (Chair 2000-2002); Special Master, CA State Bar Association for Search Warrants under Penal Code 1524 (2001-2002).