RECENT APPROACHES TO THE TRADE OR BUSINESS REQUIREMENT OF SECTION 174: UNAUTHORIZED SNOW REMOVAL

Daniel S. Goldberg*

I. Introduction

Section 174 of the Internal Revenue Code is a “tax incentive” provision designed by Congress to encourage investment in start-up research and development activities by permitting a current tax deduction for expenditures which would otherwise be considered capital expenditures. As with many tax incentive provisions, one might quarrel with the wisdom of using the tax code to encourage specific activities or expenditures and a strong argument could certainly be made against Congressional enactment of that kind of expenditure. Exercising its legislative prerogative, however, Congress chose otherwise, and it is the responsibility of the Department of the Treasury and the courts to carry out the legislative will of Congress.

Like many tax-incentive provisions of the Code, however, section 174 has inspired its share of abusive tax shelters formed solely to generate artificial tax losses. Several of those shelters have found their way to the Tax Court and a few appellate courts. Instead of focusing on the abusive aspects of those cases, however, courts have often issued very broadly-written opinions. In doing so, they may have planted the seeds for virtually precluding the availability of section 174 for all but established companies, in contravention of Congress’ clear legislative intent.

The leading cases share the same basic fact pattern. A partnership (or S corporation) engages in questionable research activities, but prior to the time any research is actually done, the entity, in substance, disposes of any interest it may have in the new technology in exchange for a stream of royalty payments from a licensee. Generally, the licensee is either the company that has also been

* Associate Professor of Law, University of Maryland School of Law; Of Counsel, Frank, Bernstein, Conaway and Goldman, Baltimore, Maryland. The author wishes to express his gratitude to Lana S. Ward, an associate at Frank, Bernstein, Conaway & Goldman, for her assistance in preparing this article.
hired to do the research or an affiliate of that company.\footnote{1}{See Green v. Commissioner, 83 T.C. 667 (1984) (research contractor received an immediately effective and comprehensive right to exploit any technology it developed) and its progeny Spellman v. Commissioner, 52 T.C.M. (CCH) 298 (1986), aff'd, 845 F.2d 148 (7th Cir. 1988) (the license agreement was entered into prior to the research activity and precluded the taxpayer from entering the business area in which the research was to be conducted) and Levin v. Commissioner, 87 T.C. 698 (1986), aff'd, 832 F.2d 403 (7th Cir. 1987) (upon execution of the research and development interest the exploitation rights were simultaneously sold).}

In these cases, the courts have correctly held that the taxpayers did not incur research and development expenses in connection with a trade or business and, therefore, were not entitled to a current deduction for their purported research and development expenses. The licensee firms, which owned the technology, incurred the expenses of research and development rather than the taxpayers. Any opportunity the taxpayers had to engage in a trade or business involving the creation or exploitation of the new technology was precluded by the licensing of the technology prior to any research expenses which the taxpayer might have incurred.

In several recent technical advice memoranda and in cases in litigation, however, the Internal Revenue Service has indicated that it will attempt to broaden the scope of the disallowance to situations in which the technology has not been pre-sold.\footnote{2}{See Tech. Adv. Mem. 8,802,007 (September 30, 1987); Tech. Adv. Mem. 8,749,006 (August 14, 1987); Tech. Adv. Mem. 8,725,001 (March 10, 1987).} The Service's attempts have been bolstered by judicial opinions in which the courts have not been content to rest their analyses on easily supportable grounds,\footnote{3}{See infra notes 28 to 51 and accompanying text.} choosing instead to focus on the "trade or business" issue. In doing so, the courts have clouded the clear guidance on the "trade or business" issue under section 174 provided by the Supreme Court in \textit{Snow v. Commissioner}\footnote{4}{416 U.S. 500 (1974).} and have thereby set the tax law back fifteen years by creating unwarranted uncertainty on the law. This article asserts that the Supreme Court would have reversed its holding in \textit{Snow} if it had applied the literal application of the post-\textit{Snow} decisions. Accordingly, that language should be disregarded as inconsistent with \textit{Snow}.

As a starting point for the analysis, this article examines the legislative history of section 174 and the historical background of \textit{Snow}. After a discussion of the \textit{Snow} case, the article reviews the
post-Snow decisions and their discussion of the “trade or business” issue. Next, to prevent the loose reasoning of the post-Snow opinions from obliterating section 174’s true purpose, the article suggests the proper mode of analysis of the “trade or business” issue under section 174. Finally, a hypothetical is used to demonstrate the correctness and efficacy of the article’s proposed analysis. The implications of the analysis and discussion, however, extend far beyond section 174. The implications underscore the importance of careful reasoning in tax cases and the need to avoid analysis based solely upon the “smell test.”

II. THE LEGISLATIVE HISTORY OF SECTION 174 AND THE Snow CASE

Section 174(a)(1) provides, “A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.” In general, expenditures for the creation of an asset must be capitalized and added to the basis of that asset. Thus, under general principles of capitalization, research expenses would not be currently deductible but rather would have to be capitalized as a cost of the technology or patent. Section 174, however, by election of the taxpayer, provides two functions: (1) it allows a current deduction for an expenditure that would otherwise have to be capitalized and included in the basis of the technology developed; and (2) it allows a current deduction for what otherwise would constitute pre-opening expenses. Even before the enactment of section 174, the Commissioner accepted the currently deductible nature of research costs in the context of an ongoing business if it was consistent with the taxpayer’s method of accounting. Section 174, in part, codified the Commissioner’s position. The Internal Revenue Service’s and re-
cent court attacks on research and development expense deductions, however, appear to focus on the latter of the two functions of the section.

The key consideration is that these attacks should not hinder the primary purpose for which section 174 was enacted, which is to encourage research and development expenditures by smaller enterprises. Section 174 was enacted to cure a problem which President Eisenhower summarized in his budget message to Congress in 1954:

At present, companies are often not permitted to deduct currently for research or development expenses. This rule is especially burdensome to small concerns because large companies with established research laboratories can usually get immediate deductions. I recommend that all companies be given an option to capitalize or to write-off currently their expenses arising from research and development work. Our tradition of initiative and rapid technical im-

facilities or his product, may at his option deduct such expenses from gross income for the taxable year in which they are incurred or treat such articles as a capital asset to the extent of the amount so expended.

Reg. 65, Art. 168 (1924).

The option provided by the Treasury in 1924, however, was short-lived. In 1925, the Board of Tax Appeals rendered two decisions which led to the withdrawal of the option to deduct or capitalize. In both of these cases, taxpayers who had previously deducted research expenses as ordinary and necessary expenses attempted to retroactively change their method of accounting and capitalize their research and experimental expenditures. See Goodell-Pratt Co. v. Commissioner, 3 B.T.A. 30 (1925); See also Gilliam Mfg. Co. v. Commissioner, 1 B.T.A. 967 (1925). The Board of Tax Appeals sided with the taxpayer in both cases. As Judge Trammell stated: “The taxpayer has no option to treat expense items as capital or capital expenditures as ordinary and necessary expenses of carrying on a trade or business and had a right, as it did, to change its erroneous accounting methods.” Gilliam Mfg. Co., 1 B.T.A. at 970.

Apparently, the Service still believed in the wisdom of allowing a current deduction for research expenditures, but was unwilling to permit taxpayers to retroactively change their method of accounting in order to take advantage of more valuable deductions after a tax rate increase. In 1952, the Commissioner stated that the policy of the Service was to allow a deduction of research costs in cases in which the taxpayer had adopted a practice of expensing them under its “established method of accounting.” Commissioner’s statement to the Joint Committee on Internal Revenue Taxation, 525 CCH *6170 (April 4, 1952). The apparently unintended implication of the Commissioner’s statement was that in order to currently deduct research costs, a business must have had a history of research and development expenditures. The implication resulted in discrimination against small or beginning businesses, and that discrimination was the primary motivating force behind the legislative response embodied in §174.

* See infra notes 10 through 13 and accompanying text.
provements must not be hampered by adverse tax rules.10

During debate on section 174's passage, Congressman Reed, then Chairman of the House Committee on Ways and Means, aptly stated the important rule which Congress intended for the section:

Very often, under present law, small businesses which are developing new products and do not have established research departments are not allowed to deduct these expenses despite the fact that their large and well established competitors can obtain the deduction. . . . This provision will greatly stimulate the search for new products and new inventions upon which the future economic and military strength of our Nation depends. It will be particularly valuable to small and growing businesses.11

Section 174, however, went further than merely codifying existing law. Section 174, like section 162,12 requires a "trade or business" to support a deduction. Unlike section 162, however, which requires a taxpayer to be engaged in "carrying on" a trade or business, section 174 requires only the lesser standard that the expenditure be "in connection with" a trade or business. Section 174 allows a current deduction for expenses that would be regarded as "start-up" expenses for purposes of section 162.13

12 Section 162 provides, in part, "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ."
13 The Congressional discussions during consideration of §174 indicated that Congress intended to provide special favorable treatment for start-up expenses in the nature of research and development expenses. Congress did this in order to prevent discrimination against taxpayers engaged in research activities without ongoing businesses and provide an incentive for small or beginning businesses to engage in research and development work.

The report of the House Ways and Means Committee on General Revenue Revision, 83rd Cong., 1st Sess. (1953) echoed this theme:

The present policy is helpful only to taxpayers which have a prior practice of expensing such costs. It discriminates against all others, including new taxpayers. In order to avoid discrimination and treat all taxpayers on an equal basis, irrespective of past accounting practices, the Internal Revenue Code should . . . be amended to give all taxpayers the option to expense or capitalize research and development expenditures.

Id. at 944.

See also the resolution adopted by the Council of State Chambers of Commerce, which was made a part of the House Ways and Means Committee Report on General Revenue Revision, at 958 and which states: "A wider latitude in the allowance of depreciation, obsolescence, and the research type of costs would encourage the development of new enterprises, the promotion of new products, and the expansion of production and employment."
The seminal judicial interpretation of section 174 was *Snow v. Commissioner* in which the taxpayer was a limited partner in the Burns Investment Company, which was a partnership formed to develop a special purpose incinerator. The partnership had made expenditures in connection with the development of the incinerator and had thereby incurred losses in the year at issue. The partnership deducted these expenditures under section 174(a)(1) of the Code, which allows a taxpayer to take as a deduction "experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account." The partnership, however, had made no sales of incinerators in the year at issue.

The Service disallowed as a deduction the taxpayer's distributive share of the partnership's net operating loss on the grounds that the partnership was not yet engaged in a trade or business during the year at issue. The Supreme Court, noting the many references to the words "trade or business" throughout the Code, held that the taxpayer was entitled to his distributive share of partnership losses because the partnership had incurred those expenses "in connection with" its trade or business.

Id. at 958. See also the remarks of Representative Camp, Revenue Revision Act, 82nd Cong., 1st Sess., 97 Cong. Rec. 4326 (1951):

In order to clarify the existing confusion in respect of the tax treatment of such expenditures, and to prevent tax discrimination between large businesses having continuous programs of research and small or beginning business enterprises, §174 provides generally that expenditures made in industrial or commercial research...may, at the election of the taxpayer, be deducted as expenses or capitalized and charged off over a period selected and designated by the taxpayer.

Id.

The Treasury Department also understood that the intended purpose of §174 was to encourage research by new or small business enterprises. During the course of the enactment of the 1954 Code, Undersecretary Marian B. Folsom presented a summary of the principal provisions of H.R. 8300 to the Senate Finance Committee. During this presentation, he indicated that the existing treatment of research and experimental expenditures discouraged research and was "essentially restrictive for small businesses" and that §174 would "help small, pioneering businesses." Senate Finance Committee Hearing on H.R. 8300, 83rd Cong., 2nd Sess. 105 (April 7, 1954).

15 See id.
17 See 416 U.S. at 502.
18 See id. at 503-04.
In the Court's view, the phrase "in connection with" contained in section 174 of the Code, encompasses activities engaged in by the taxpayer in the area of research and development, even though the taxpayer has not yet begun the actual sale of products it developed.\(^{19}\) The Court reasoned that a more relaxed standard for deductibility under section 174 than under section 162 emanated from Congress' intent to equalize treatment with regard to research and development expenditures between rich taxpayers and poor taxpayers.\(^{20}\)

In the Supreme Court's view, to have required taxpayers to be already engaged in activities of selling products to qualify for the research and development deduction would have caused disallowance of deductions for small businesses which are developing new products and do not yet have established research departments. Nonetheless, large and well established competitors would have been allowed deductions for those same expenditures.\(^{21}\) Such a result would have been unusual and inappropriate for a provision which was designed specifically with small and growing businesses in mind.\(^{22}\)

\(^{19}\) See id. at 503. The sale of goods and services is no longer a prerequisite to deductibility under §162. See infra notes 63 to 70 and accompanying text.

\(^{20}\) See 416 U.S. at 503.

\(^{21}\) See id. at 504.

\(^{22}\) See id. at 503-04. Although the Supreme Court's interpretation of §174 reveals one pervasive theme which is that §174 was intended to encourage research and development work by "small or beginning business enterprises" in start-up situations—several courts, including the Tax Court, were not willing to give such broad effect to the new section after its enactment. See generally, Lee, Pre-Operating Expenses and Section 174: Will Snow Fall?, 27 Tax Lawyer 381 (1974) (discussing the history of §174 prior to the Snow decision).

In 1960, and again in 1961, the Tax Court had an opportunity to apply §174 to new enterprises. In Cleveland v. Commissioner, 34 T.C. 517 (1960), aff'd in part, rev'd in part, 297 F.2d 169 (4th Cir. 1961), the taxpayer, Cleveland, had been advancing funds to an inventor attempting to develop an inorganic liquid binder for at least 12 years prior to the enactment of §174. Prompted by the enactment of §174, Cleveland and Kerla, the inventor, entered into a "trust agreement" in 1956, reducing their understanding to writing. The agreement provided that the inventor was to spend his full time working on the invention and that Cleveland held a one-half interest in the invention. The Tax Court held that the agreement failed to create a partnership or joint venture and, therefore, Cleveland was not engaged in business with Kerla. Id. Instead, the Tax Court held that the funds advanced by Cleveland subsequent to the written agreement were loans to the inventor. Id.

In partially reversing the Tax Court's decision, the Court of Appeals for the Fourth Circuit stated, "if there was a joint venture in which both men were active participants, the actual expenditures by Kerla for research and experimentation could be deducted by Cleveland since they were incurred in connection with his trade or business." Cleveland, 297 F.2d
The Supreme Court did not explicitly set forth the meaning of §174 at 172. The Court went on to hold that the parties were involved in a joint venture and that the funds advanced subsequent to the agreement were deductible under §174: “In this instance the decision of the parties to the agreement to define their relationship so as to take advantage of the benefits of the statute was in harmony with the purpose of the enactment to encourage expenditures for research and experimentation.” Id. at 173.

The facts of Cleveland do not indicate that the invention was ever actually marketed or that any patent was applied for. Yet the Court of Appeals did not question the existence of a trade or business as that term is used in §174. (The continuing nature of the equal co-ownership in Cleveland has recently been used to distinguish Cleveland from other research and development cases on the grounds that the capital partner did not retain a significant ownership interest after the research contractor licensed the technology. See infra note 114 and accompanying text.

Before the appellate court issued its opinion in Cleveland, the Tax Court was confronted with another new enterprise case under §174 in Koons v. Commissioner, 35 T.C. 1092 (1961). Koons had purchased all rights to an invention which was in a stage of very early development. Koons then contracted with the seller, a research laboratory, to complete the development work. The Service challenged Koons' deductions for research expenditures under §174 as not incurred in connection with a trade or business. The Tax Court held that the term “trade or business” as contemplated in §174 required a “going” or “existing” trade or business. ld. at 1100. Interestingly, the Court cited only those portions of the legislative history which did not refer to “new” or “beginning” enterprises. The Tax Court then analogized to cases decided under §162 and concluded that the developmental expenditures involved in Koons were not made in connection with an existing trade or business, and therefore were not deductible. ld. at 1101.

It was against that background that the case of Snow v. Commissioner, 58 T.C. 585 (1972) reached the Tax Court. In that case the taxpayer, Snow, was one of three limited partners in the Burns Investment Company partnership. The partnership was formed in July of 1966 by Trott, an inventor, in order to secure funds necessary for further development of a new type of incinerator. Trott contributed all right, title and interest in the incinerator to the partnership, and the limited partners contributed capital. Burns Investment Company hired Crossbow, Inc. to perform all the shop work necessary for further development of the incinerator. Id. On its 1966 tax return, Burns Investment Company reported a net operating loss in excess of $36,000. During 1966, Burns Investment Company was not involved in selling the incinerator or any other product. On these facts the Tax Court held that the expenditures paid in 1966 were not incurred “in connection with” the trade or business of the partnership since the partnership was not in a trade or business in 1966. The court stated, “In 1966 Trott had hardly begun experimentation upon the trash burner, the application for a patent was not made until 1968, the advance of funds was made only in 1966 and no effort to market or sell the device was attempted until several years later.” Id. at 595. Citing its earlier decision in Koons, the Tax Court found that since Burns Investment Company “was not holding itself out to others as engaged in the selling of goods or services[,]” the research expenditures were not incurred in connection with an existing trade or business. Id. at 597. Thus, the Tax Court extended its holding in Koons to incorporate the full “trade or business” test of §162.

On appeal, the Sixth Circuit agreed with the imposition of the trade or business requirement of §162. The court stated, “[i]t seems clear to us, as it did to the Tax Court, that Burns Investment Company in 1966 was not holding itself out to others as being engaged in the selling of goods and services.” 482 F.2d 1029, 1031 (1973). The court held that the expenses incurred by Burns Investment Company in 1966 were “pre-operating” expenses and,
the "trade or business" language in section 174. The outcome in Snow, however, suggests a liberal application of the term. Under the Snow decision, section 174 does not require that the taxpayer be engaged in carrying on a trade or business. In 1966, the year in issue, the Burns Partnership had no office, telephone, or separate facility of any kind. No patent had been applied for, and the partnership itself did no work on the invention. Instead, the partnership hired a company owned by the general partner to perform engineering and development services. Although the regulations under section 174 provide that a deduction will be allowed for expenditures incurred on behalf of the taxpayer by another person or organization, in Snow, there was no written contract between the partnership and the company performing the development services.

More importantly, under Snow, a taxpayer need not ever carry on a trade or business within the meaning of section 162. Snow conceded that the partners had not made any marketing efforts on behalf of the Burns Partnership in 1966. In fact, the partnership never made any attempt to market the product at all. Before a patent was issued in 1970, the partnership incorporated to produce thus, were not deductible under §174. Id. at 1032. When confronted with the legislative history of §174, the Court stated: "We cannot hold that the comment previously quoted from Representative Camp concerning 'beginning enterprises' demonstrates a Congressional intent to set aside the settled interpretation of the language 'trade or business' as used in §174." Id. at 1032. This holding by the Sixth Circuit created a clear conflict with the holding of the Fourth Circuit in Cleveland, and thus set the stage for review by the Supreme Court.

In his brief to the Supreme Court in Snow, the Commissioner argued that by incorporating the "trade or business" language in §174, Congress made clear its intent to incorporate the "trade or business" requirement of §162. Brief for the Respondent at 11, Snow v. Commissioner, 416 U.S. 500 (1974). However, the Commissioner failed to recognize the language in §174 which distinguishes it from all other Code sections. Section 174 provides a deduction for research expenditures "in connection with" a taxpayer's trade or business. In contrast, §162 provides a deduction for "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" (emphasis added)." It was precisely that distinction that formed the basis for the Supreme Court's opinion.

The Supreme Court rejected the arguments of the Commissioner and held that the language and requirements of §162 were "not helpful" in construing §174. 416 U.S. at 503. In a unanimous decision, the Supreme Court relied heavily on the legislative history of §174. In the Court's opinion, imposing the stringent standards of §162 upon the more liberal provision of §174, would result in the same discrimination that Congress intended to alleviate by enacting §174. Id. at 504.

See Brief for Respondent at 5, 416 U.S. 500.

See id.
and market the device.\textsuperscript{25} Thus, it is clear that the Burns Partnership \textit{never} engaged in carrying on a trade or business within the meaning of section 162 and perhaps never intended to do so.

The Court, however, presupposed that Snow was in the pre-opening phase of a trade or business without discussing what constitutes that phase. In general, the pre-opening phase of a trade or business ends when the activities for which the enterprise was formed begin with a \textit{bona fide}, good faith expectation of profit. Courts, however, differ regarding which events trigger the commencement of these activities.\textsuperscript{26}

The Service has recently begun to attack certain transactions as not being within the pre-opening stage of a trade or business because the taxpayer never intended to carry on a trade or business. It is on this critical issue that the Service has demonstrated its failure to understand the concept of "trade or business" and the Supreme Court's holding in \textit{Snow}.

III. \textit{Green} and Its Progeny: The Recent Erosion of \textit{Snow}

For several years following the \textit{Snow} decision, there were no decided cases. The Service itself was silent. During those years, however, many research and development partnerships were formed based upon the holding of the \textit{Snow} decision that a current deduction under section 174 did not require the taxpayer to be currently engaged in carrying on a trade or business. The Department of Commerce encouraged such ventures, providing blueprints for structuring them, virtually in kit form.\textsuperscript{27}

In 1984, judicial silence came to an end with the Tax Court's decision in \textit{Green v. Commissioner},\textsuperscript{28} which formed the cornerstone of the Service's recent attacks on the "trade or business" issue. The \textit{Green} case was followed by \textit{Spellman v. Commissioner}\textsuperscript{29} and

\textsuperscript{25} See id. at 5-6.
\textsuperscript{26} See, e.g., Blitzer v. United States, 684 F.2d 874 (Cl. Ct. 1982); McManus v. Commissioner, 54 T.C.M. 475 (1987); Richmond Television Corp. v. U.S., 345 F.2d 901 (4th Cir. 1965), vacated and remanded on other grounds, 382 U.S. 68 (1965). Presumably, future regulations promulgated under §195 will end this controversy.
\textsuperscript{27} See e.g., Information and Steps Necessary to Form Research and Development Limited Partnerships, U.S. Department of Commerce, (December 31, 1983), P.B. 84-156058.
\textsuperscript{28} 83 T.C. 667 (1984).
\textsuperscript{29} 52 T.C.M. (CCH) 298 (1986), aff'd, 845 F.2d 148 (7th Cir. 1988).
Levin v. Commissioner, both of which were affirmed for the Commissioner on appeal, and by several subsequent Tax Court and Tax Court Memorandum cases.

The Green case involved a limited partnership ("LaSala") which in December of 1979 acquired four inventions from several inventors. On the same day that the partnership acquired those inventions, it executed a research and development agreement and an exclusive license agreement with a patent development company ("NPDC"). Under the terms of the exclusive license agreement, NPDC was granted an immediate, worldwide license to commercialize, manufacture, sell and otherwise exploit the inventions. LaSala claimed a deduction under section 174 for research and experimental expenditures in the amount of $650,000, which it paid for further development of the inventions during the period after the effective date of the licensing agreement.

The Service challenged LaSala's deductions for research and development expenses because those expenditures related to a period after the date of the disposition of the inventions to NPDC under

30 87 T.C. 698 (1986), aff'd, 832 F.2d 403 (7th Cir. 1987).
31 See, e.g., Diamond v. Commissioner, 92 Curr. Tax Ct. Reg. Dec. (CCH) No. 25, Dec. 45,497 (1989)(deduction denied when option could be exercised w/o cost and partnership was otherwise precluded from obtaining a patent for the device developed); Moore v. Commissioner, T.C.M. 1989-38 (January 24, 1989)(Partnership denied deductions under §174 for suspect research in a transaction devoid of profit motive to the partnership and in which the option to license the resulting technology was prearranged or a foregone conclusion). McManus v. Commissioner, 54 T.C.M. (CCH) 475 (1987), aff'd, 865 F.2d 255 (4th Cir. 1988)(S corporation that purportedly was to conduct research on developing a prototype mud logging device, which had precluded itself from all activities to exploit the technology, like the partnership in the Green case, was denied research and development expense deduction) and Property Growth Company v. Commissioner, 55 T.C.M. (CCH) 1072 (1988)(sustained Commissioner's disallowance of the taxpayer's research and development expense deduction). See also, Ben-Avi v. Commissioner, 55 T.C.M. (CCH) 199 (1988) (contemporaneous license precluded trade or business); Goulding v. Commissioner, 55 T.C.M. (CCH) 846 (1988) (expenditures for research in ginsing cultivation disallowed where partnership retained no rights in the technology). Other cases involving suspect research have been decided against taxpayers based upon lack of profit motive. See e.g., Mack v. Commissioner, 55 T.C.M. (CCH) 735 (1988) (expenditures for development of a calorie consumption monitor, "DietMate", disallowed on the basis of lack of profit motive where research, if any, was suspect, and transactions allegedly involved a Virgin Island partnership, a Hong Kong research contract, and financing from a Swiss bank without documentation); Myslisz v. Commissioner, 55 T.C.M. (CCH) 818 (1988) (profit motive lacking where the taxpayer owned the technology, but failed to monitor the progress of the research, could not realize a profit without tax benefits and where the technology was not "stand alone" technology).
32 See 83 T.C. at 668-72.
the terms of the exclusive license agreement. The Tax Court held that the exclusive license agreement between LaSala and NPDC constituted a sale of those inventions. Because the sale took place before LaSala made its research and development expenditures, these research costs were not expended in the partnership's behalf. Rather, the court stated that these expenditures represented an acquisition cost of NPDC's promise to pay a stream of royalties to LaSala. The LaSala partnership could never enjoy the benefits of the research, other than through royalty participation, because it had already divested itself of all rights to the inventions. Moreover, the Tax Court held that the expenditures could not have been made "in connection with" any trade or business because, prior to making these expenditures, the partnership had precluded itself from entering into a trade or business through the exploitation of the research. Nor could LaSala be considered to be in the trade or business of research for future exploitation because it had already sold its rights to any product that might arise from the research. Therefore, based on the simultaneous purchase and sale agreements through which LaSala sold the very technology it claimed to be developing, the Tax Court concluded that the partnership had carried on solely investment activities because it functioned only "as a vehicle for injecting risk capital into the development and commercialization" of the inventions.

Research and development activity, whether done by a partner or someone else for the LaSala partnership, clearly would have established the partnership as being engaged in a trade or business if those activities were done on the partnership's behalf. In the Green case, however, the activities were engaged in on behalf of NPDC, the licensing corporation, rather than the partnership. Therefore, those activities did not establish the partnership in the trade or business.

Since the research activities were not done on LaSala's behalf, the court examined the other activities of the partnership to determine whether those activities were sufficient to constitute a trade

33 Id. at 678.
34 Id. at 684.
35 Id. at 685-91.
36 Id. at 691.
37 Id. at 687.
or business. Those activities, however, consisted purely of ministerial activities such as maintaining bank accounts and making deposits. The court likened LaSala’s royalty interest in the development and commercialization of the inventions to that of an investor in securities. The partnership had no ownership interest in the inventions and no control over their actual development, production or marketing. Rather, the partnership only maintained an interest in the investment because the purchase price under the license agreement was contingent upon future sales by the licensee.

The Tax Court’s opinion in the Green case, however, is far from a model of clarity. The language of the opinion could be read to give the investment factors discussed by the court significance independent of the simultaneous licensing arrangement on which the court based its conclusion that the taxpayer had no trade or business. To grasp the importance of the Green case, one must examine it in light of the Supreme Court’s decision in Snow. Given such an analysis, the simultaneity of the licensing and research and development agreements takes on crucial significance.

Two later Tax Court cases, Spellman v. Commissioner and Levin v. Commissioner expressed the significance of this relationship much more clearly. Indeed, these cases indicate that a taxpayer’s entitlement to a research and development deduction under section 174 of the Code will depend on whether that taxpayer has, in effect, sold (i.e., licensed on an exclusive basis) the technology prior to the conduct of the research activity.

In Spellman, the taxpayer was a limited partner in a partnership created to invest in another limited partnership, Sci-Med, which was formed for the purpose of engaging in the research, development and exploitation of certain antibiotic drugs. An Israeli pharmaceutical company, Teva Pharmaceutical Industries, Ltd. (“Teva”), agreed to undertake a research and development program for Sci-Med under a sub-research and development agreement. On the same day the parties entered into the research and development agreement, Sci-Med granted Teva the sole and exclu-

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38 Id. at 688.
39 Id. at 688-89.
40 52 T.C.M. (CCH) 298 (1986), aff’d 845 F.2d 148 (7th Cir. 1988).
41 87 T.C. 698 (1986), aff’d, 832 F.2d 403 (7th Cir. 1987).
sive worldwide license to manufacture and sell the products that resulted from the technology developed as well as the right to sub-license the technology.\textsuperscript{42}

The Tax Court held that Sci-Med was not entitled to any research and development deduction under section 174 of the Code.\textsuperscript{43} In so holding, the court clearly identified the simultaneous research and exclusive license agreements as the single significant factual finding because the simultaneity of these agreements ensured that all of Sci-Med's rights to the technology developed would belong to Teva even before research was conducted. As a result, any research conducted pursuant to the research agreement would necessarily be for the benefit and account of Teva rather than Sci-Med. Accordingly, Sci-Med could not be entitled to the section 174 deduction. Indeed, as the court itself stated:

Since the exclusive license agreement was entered into by Sci-Med prior to the commencement of any research or experimental activities, Sci-Med was effectively precluded from ever having a substantial right in the results of the said activities, and from ever using the results of the research or experimental activities in connection with its own trade or business, present or future. Sci-Med's role was exclusively that of a financing vehicle, injecting risk capital into the venture. Its activities never, and could have never, surpassed those of an investor.\textsuperscript{44}

As the above-quoted passage from the Court's opinion indicates, the existence of current trade or business activities or even the assurance of future trade or business activities by the taxpayer is not the essential factor in determining whether a taxpayer's research expenditures were made "in connection with a trade or business." Rather, the ability to engage in a trade or business in the future is the touchstone.

In affirming the decision of the Tax Court, the Court of Appeals for the Seventh Circuit emphasized the importance of the pre-licensing by pointing out that "the plan might have worked if Sci-Med had had good prospects of entering the pharmaceutical business."\textsuperscript{46} However, the pre-licensing of virtually all of the technol-

\begin{itemize}
  \item \textsuperscript{42} 52 T.C.M. (CCH) at 300-01.
  \item \textsuperscript{43} Id. at 310.
  \item \textsuperscript{44} Id. at 307.
  \item \textsuperscript{46} Spellman v. Commissioner, 845 F.2d. at 151.
\end{itemize}
ogy, other than "by-products" (which were subject to an option exercisable for only $20,000), prevented Sci-Med, as a practical matter, from ever entering the pharmaceuticals business.\(^{46}\)

In the Spellman case, as in the Green case, the taxpayer's exclusive license of virtually all of the technology to another firm prior to the actual research precluded the taxpayer from ever carrying on a trade or business in connection with the technology developed. One may fairly infer from both the Spellman and Green opinions that, but for the preclusion of any future exploitation of the technology engendered in the pre-licensing agreement, the taxpayer's position would have been sustained.

Similarly in Levin v. Commissioner,\(^{47}\) the taxpayer, a limited partner in a partnership organized to develop, manufacture, and market food packaging systems, sought a section 174 deduction even though the partnership had simultaneously executed a research, manufacturing, and marketing agreement with another firm. The Commissioner contended that the partnership was precluded by contractual arrangements and by design from ever engaging in any trade or business. The court articulated the question as follows: "[W]e must decide only whether the partnerships were engaged, at any time, in the trade or business in connection with which funds were expended for research and experimentation within the meaning of section 174."\(^{48}\) Under the court's formulation of the issue, the Commissioner prevailed because the simultaneous execution of the manufacturing, marketing and development agreements effectively precluded the taxpayer's partnership from being "capable of ever engaging in trades or businesses."\(^{49}\) The manufacturing and marketing agreements, which may or may not have effected sales of the packaging machinery inventions, effectively deprived the partnership of control over the manufacture, use and sale of the developed machines for virtually the entire life of the partnership. In the absence of these agreements, however, the court could not have concluded that the partnership would or could never enter into a trade or business in the future.\(^{50}\)

\(^{46}\) Id.
\(^{47}\) 87 T.C. 698 (1986), aff'd, 832 F.2d 403 (7th Cir. 1987).
\(^{48}\) Id. at 725.
\(^{49}\) Id. See also id. at 726-28.
\(^{50}\) In its opinion in Levin, the court looked past the technical and legal issues involved in the case, and instead emphasized that the research at issue was suspect. The court's interest
On appeal, the Court of Appeals for the Seventh Circuit, in distinguishing Snow, emphasized that the partnership in Snow invested in the development of the ideas of its general partner, an inventor. Moreover, the court stated that in Snow, "the partnership expected to produce and sell the machines itself, if development efforts were successful." In contrast, the partnerships in Levin were formed only to supply cash so that inventions could be developed by others. Further, the general partner was not an inventor and had no experience with food machinery.

Thus, the facts of the case, in the court's view, contained four serious obstacles that the taxpayer needed to overcome in order to prevail. First, the research was suspect. Second, the accrued deduction for research services was based upon a future liability stated in declining currency. Third, the general partner of the partnership was not an inventor. Fourth, the partnership never actually intended to sell the inventions in Israel or anywhere else.

The courts in Green, Spellman, and Levin all reached the appropriate result. The language in the opinions of these cases, however, was also piqued by the method of payment under the several agreements, which suggested a currency-swap arbitrage. The taxpayer sought an accrual for the current value of a liability payable in Israeli currency several years in the future. Because of the rate of inflation and decline of the Israeli currency, it was predictable, almost to a certainty, that the value in U.S. dollars of the contractual liability would be substantially less than the original accrual. The accrual is significant because it overstates the true amount of the liability for future payment in U.S. dollars. 87 T.C. at 716-20.

Under §461(h), the test for determining when an expense is deductible for an accrual method taxpayer is the "all events test." Under the all events test, in general, an expense of an accrual method taxpayer is deductible in the taxable year in which: (1) "all the events have occurred which determine the fact of the liability;" and (2) the amount of the liability "can be determined with reasonable accuracy." See also Treas.Reg. §1.461-1(a)(2).

The amount of the §461(h) deduction is the face amount of the liability for future payment, without discounting to present value. The rule has substantial support in the case law dating back almost to the inception of the income tax laws. See, e.g., United States v. Anderson, 269 U.S. 422 (1926); Lawyer's Title Guarantee Fund v. United States, 508 F.2d 1 (5th Cir. 1975). It recently has been reaffirmed by the Tax Court in Burnhaum Corp. v. Commissioner, 90 T.C. 953 (1988)(accrual of estimated amount of settlement payments was proper where the settlement agreement specified the amount of each monthly payment which was to be paid until the death of the payee and taxpayer used actuarial tables to determine life expectancy). In Levin as well as other Green progeny, by previous license agreement, the taxpayer had precluded itself from ever engaging in any trade or business with regard to the technology because the technology was developed at a time when the taxpayer had no ownership interest in it.


82 See id.
ever, was imprecise and overly broad, suggesting an improper analysis which could undermine the Congressional purpose for enacting section 174.

IV. A Suggested Analysis of the Trade or Business Issue Under Section 174.

The critical fact in the Green case and its progeny was that the taxpayers were in all respects non-participants. From the inception of the transactions, none of the participants was ever going to own or exploit the technology. All of the situations represented merely financing devices disguised by meaningless agreements. In that sense, they were similar to typical sale-leaseback financing arrangements. Under those arrangements, the nominal ownership of the lessor is ignored for tax purposes. Instead, the lessee is entitled to the tax benefits of the arrangement, such as depreciation deductions, because he bears the benefits and burdens of ownership. Section 174 was not designed to artificially shift deductions for research and development expenses, and the transactions in Green and its progeny represented crude attempts to do just that.

Yet, several of these cases appear to rest their decisions more generally on the taxpayer's lack of a trade or business, rather than simply the circularity of the transactions and the taxpayer's lack of ownership of the technology. To the extent that these decisions rely on the "trade or business" analysis, they are misleading. Ac-

53 See, e.g., Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985)(purchase of used computer equipment with recourse and nonrecourse notes for price in excess of fair market value followed by leaseback was a sham lacking economic substance); Beck v. Commissioner, 678 F.2d 818 (9th Cir. 1982)(partnership denied interest deduction where purchase price and nonrecourse indebtedness incurred by the partnership greatly exceeded the fair market value of property securing the debt); Hilton v. Commissioner 671 F.2d 316 (9th Cir. 1982), cert. denied, 459 U.S. 907 (1982)(purchase-leaseback was not a genuine multi-party transaction with economic substance where there was no possibility of economic profit or gain); Sun Oil v. Commissioner, 562 F.2d 258 (3d Cir. 1977), cert. denied, 436 U.S. 944 (1977)(conveyance of 320 parcels of unimproved service station sites at cost to a tax-exempt trust, with leaseback, was mere financing transaction where lessee bore all risks and burdens of ownership of the property and guaranteed a fixed return); Johns v. Commissioner, 53 T.C.M. (CCH) 442 (1987)(sale-leaseback between related taxpayers lacked business purpose, economic substance and reasonable chance of profit, and was designed solely to obtain tax benefits); But see, Frank Lyon Co. v. United States, 435 U.S. 561 (1978)(sale-leaseback shall be respected where there is a genuine multi-party transaction with economic substance and when compelled or encouraged by business or regulatory realities and imbued with non-tax considerations)
Accordingly, the trade or business issue should be put in proper perspective.

A. Trade or Business

Although the Supreme Court in Snow declined to define the term "trade or business," it recently dealt with the concept more definitively in Commissioner v. Groetzinger. In Groetzinger, the Supreme Court held that a gambler who gambled on a full-time basis solely for his own account was in a "trade or business" for purposes of the minimum tax provisions of the Code, and presumably for purposes of other provisions of the Code as well. In so holding, the Supreme Court rejected the requirement that a taxpayer must offer goods or services to be considered engaged in a trade or business. Instead, the Court stated: "To be engaged in a trade or business, the taxpayer must be involved in the activity with continuity or regularity and . . . the taxpayer's primary purpose for engaging in the activity must be for income or profit."

In Groetzinger, the taxpayer relied upon his gambling activity for his livelihood, although he had certain investment income as well. The court indicated that the activities of a gambler could be seen in three different ways: (1) as a trade or business, (2) as a mere "hobby or a passing fancy" such as "an occasional bet for amusement," and (3) as an investment. An occasional gambler's losses would likely be regarded as non-deductible personal consumption rather than losses incurred in either a trade or business or a transaction entered into for profit. The fact that Groetzinger gambled for a livelihood took his activity out of the realm of per-

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55 This view is generally attributed to Justice Frankfurter's concurring opinion in Deputy v. Du Pont, 308 U.S. 488, 499 (1940); see also Groetzinger, 480 U.S. at 30-31.
56 480 U.S. at 35. Although the Supreme Court looked to the taxpayer's "primary purpose" for engaging in the activity for purposes of distinguishing a profit-seeking endeavor from pure pleasure, a primary purpose test is not the appropriate test to apply in situations where there is no question of pleasure or personal consumption benefits. Rather, in those cases and, particularly, in cases involving specific "tax incentive" provisions such as §174, a "good faith profit motive" should be the applicable test. See Warren, The Requirement of Economic Profit in Tax Motivated Transactions, 59 Taxes 985 (1981). As suggested above, §174 is such a tax incentive provision and was specifically designed to encourage the precise behavior engaged in by Research One and its constituent partners. The Department of Commerce Blueprints, supra note 27, confirm this conclusion.
57 480 U.S. at 33-34.
sonal amusement and into one of the other two categories of activity.

Moreover, the continuity of Groetzinger's activity and the objective to make a profit from his personal energies rather than from appreciation in property took the activity out of the investment category and placed it in the trade or business category. Groetzinger was unlike a taxpayer whose "expenses [were] incident to caring for one's own investments even though that endeavor is full-time."\(^{58}\)

The Court, in its words, applied a "common-sense concept of what is a trade or business,"\(^ {59}\) which required "an examination of the facts in each case,"\(^{60}\) however unsatisfactory that may be. To the extent this is an unsatisfactory resolution, the Supreme Court left repair or revision, if any was needed, to Congress. But, in the context of research and development, Congress has already spoken through its enactment of section 174. As the Supreme Court recognized in the Snow case and reiterated in Groetzinger, section 162(a) "is more narrowly written than is Section 174."\(^ {61}\)

Thus, a taxpayer satisfies the trade or business test of section 162 (and, therefore, a fortiori, section 174) if (1) the activities are undertaken with a profit motive, (2) the activities are sufficiently regular and continuous, and (3) the activities constitute a business rather than an investment.\(^ {62}\)

Two questions then remain when an activity is undertaken with a profit motive. The first is whether the taxpayer's for-profit activities, even if regular and continuous, constitute an investment rather than a business. The second is whether the regular and continuous activities performed by persons on behalf of the taxpayer may be attributable to the taxpayer in establishing that his activity was regular and continuous so that the taxpayer is engaged in a trade or business.

\(^{58}\) Id. at 31. The Court had previously held that an investor's expenses are not deductible as paid or incurred in carrying on a trade or business under §162. Higgins v. Commissioner, 312 U.S. 212 (1941), but see I.R.C. §212(2), which would allow a deduction for such expenses.

\(^{59}\) Id. at 35.

\(^{60}\) Id. at 36.

\(^{61}\) Id. at 31, quoting Snow v. Commissioner, 416 U.S. 500, 503 (1974).

\(^{62}\) The Tax Court has already indicated that it will likely adopt this view. See Smith v. Commissioner, 91 Curr. Tax Ct. Reg. Dec. (CCH) No. 48, Dec. 45, 110 (1988). See also Lee, supra note 22, for a discussion of this view prior to the Snow decision.
With regard to whether the taxpayer's activities constitute a business or an investment, the Supreme Court in *Whipple v. Commissioner* held that the mere purchase and sale of assets for current income and appreciation was insufficient to establish a trade or business under section 166. In *Whipple*, the taxpayer was the majority shareholder of a bottling corporation to which he had loaned substantial amounts of money. When those debts later become worthless, the taxpayer sought an ordinary deduction for the losses as business bad debts under section 166. The Commissioner, however, viewed the debts as non-business bad debts, which would be treated as a short-term capital loss. Thus, like section 174, the availability of an ordinary deduction under section 166 depends upon a distinction between business activities and investment activities.

The Court held that *Whipple* was a mere investor and, therefore, not engaged in the trade or business of organizing and financing corporations:

> Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing. Furnishing management and other services to corporations for a reward no different than that flowing to an investor is not a trade or business.

The Court distinguished those cases in which the taxpayer was held to be in business because he received compensation for his efforts other than the normal investor's return or because he sought to immediately sell the corporations at a profit. Therefore, the *Whipple* case suggests that the existence of a trade or business under section 166, as distinguished from an investment, depends

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64 See generally I.R.C. §166(d)(2). Section 166(d)(2) provides:

(d) NONBUSINESS DEBTS.

(2) NONBUSINESS DEBT DEFINED—For purposes of paragraph (1), the term “nonbusiness debt” means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer's or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

upon a finding that the taxpayer's anticipated profit derived from the taxpayer's services rather than market appreciation.86 This test can be referred to as the "taxpayer efforts test."

A similar conclusion can be drawn under section 1221, although with less than unanimous support in the case law. In general, prior to the Tax Reform Act of 1986, gain from the sale or exchange of a capital asset received treatment under the Code preferential to that accorded ordinary income. Therefore, the distinction between an investment and a trade or business under section 1221 was of major importance. A capital asset is broadly defined in section 1221 of the Code to mean "property held by the taxpayer", but specifically excludes, inter alia, "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."87

In George R. Kemon,88 the Tax Court addressed the question of whether a partnership which regularly engaged in the purchase and sale of many different securities held those securities as an investment or for sale to customers in the ordinary course of business. The court applied the taxpayer efforts test, stating that the critical distinction was the following:

[T]hose who sell 'to customers' are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a

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86 The Court went on to explain that in order to establish a trade or business of organizing and promoting businesses for resale, "petitioner must show that the entities were organized with a view to a quick and profitable sale. . . . It is the early re-sale which makes the profits income received directly for services." Id.

In a subsequent case, Deely v. Commissioner, 73 T.C. 1081, 1092-93 (1980) the Tax Court applied and explained the distinctions raised by the Supreme Court in Whipple in the context of §166. The Tax Court focused entirely on whether the taxpayer's anticipated gain was to be derived directly for his services:

In order to establish a business separate from that of his corporations, petitioner must show that the compensation he seeks from his activities is other than the normal investor's return and that income received is directly for his services rather than indirectly through successful operation of the corporate enterprise.

Id. at 1093.
87 I.R.C. §1221(1).
88 16 T.C. 1026 (1951).
middle man bringing together buyer and seller and performing the usual services of retailer or wholesaler of goods.\(^{69}\)

The court described these persons as “dealers” and distinguished them from mere “traders” who depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost.\(^{70}\)

*Kemon* indicates that, at least as applied to securities trading, analysis of whether the taxpayers’ profits derived in the ordinary course of a trade or business under section 1221(1) turns upon the same factors discussed above in connection with sections 162 and 166 of the Code. The majority of cases arising under section 1221(1), however, involve the purchase and sale of real estate. These cases seemingly create an inconsistent pattern that cannot be reduced to a single statement of the law. Indeed, courts have even stated that earlier decisions on essentially the same facts do not have precedential effect.\(^{71}\) Nevertheless, in many of these irrec­oncilable and unpredictable cases, the same three factors emerge as the primary means used to distinguish between business activi­ties and investment activities: namely, the taxpayer must: 1) engage in substantial activity with some degree of continuity; 2) with a profit motive; 3) which profit does not depend upon market ap­preciation.\(^{72}\)

70 Id. at 1033; see also Currie v. Commissioner, 53 T.C. 185, 199 (1969).

71 See, e.g., Houston Endowment, Inc. v. United States, 606 F.2d 77, 82 (5th Cir. 1979).

72 In Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980), [hereinafter *Suburban*], cert denied, 449 U.S. 920 (1980), for example, the court noted that, “[i]n the principal recent cases, there has always been a conjunction of frequent and substantial sales with development activity relating to the properties in dispute.” Id. at 176 (citations omitted). This view clearly coincides with the factors used to establish a trade or business under other sections of the Code — substantial activity with profits to be derived from taxpayer efforts.

Indeed, even in §1221 cases, the Service has frequently urged the adoption of the taxpayer efforts test. In Buono v. Commissioner, 74 T.C. 187 (1980), the Tax Court declined to adopt that test, although it was urged by the Commissioner. In that case, the taxpayer purchased one tract of land, subdivided it, and sold it in bulk to one purchaser. The Tax Court refused to impose ordinary income treatment, but based its holding on the lack of continuing sales
under Section 1221(1) that genuinely apply a multifactor test rather than the taxpayer efforts test. However, a close examination of the precedents in this area reveals that those cases that have applied a multifactor test rely heavily on the factors that require taxpayer efforts, and would be decided the same way if the taxpayer efforts test were applied.

Divergence from the taxpayer efforts test in section 1221 can be explained by noting that section 1221 contains requirements in addition to a finding of a trade or business; namely that the taxpayer must sell to customers in the ordinary course of that trade or business. The requirement of selling to customers explains the divergence. There is no similar requirement under sections 162, 166 or 174. Indeed, the Supreme Court on several occasions has described a "business" as "that which occupies the time, attention and labor of real estate. See id. at 200. In addressing the question of taxpayer efforts, the Court stated:

The fact that a substantial amount of appreciation is due to the taxpayer's activities is, of course, a significant factor to consider in making this determination. However, such does not, standing alone, necessarily require a finding that the taxpayer's property is excluded from the capital asset definition by section 1221(1). Id. at 205 n. 25. Rather, the focus of the inquiry is whether the taxpayer's activities rise to the level of a trade or business.

Id. at 205. (emphasis added)

From this statement, one could infer that the number and substantiality of sales is essentially a "busyness" test, requiring some degree of continuity and substantial sales activity in order to establish that the taxpayer is in the business of selling real estate. Thus, the two factors cited as most important are: 1) substantial activity; and 2) taxpayer improvements. This conclusion is further supported by the Tax Court's earlier decision in Bush v. Commissioner, 36 T.C.M. 340 (1977), aff'd, 610 F.2d 426 (6th Cir. 1979).

In Bush, like Buono, there was only one sale of real estate. However, the taxpayer in Bush spent considerable time and energy in acquiring adjacent parcels of real estate, negotiating the construction of an apartment building, engaging a design firm and related activities. Before any construction occurred, however, the taxpayer sold the entire tract to one buyer. In holding that the taxpayers had entered the real estate business, the court focused exclusively on the source of the gain. In spite of a lack of continuing sales activity, the court stated that the "key" to its determination was that the gain recognized was primarily attributable to the taxpayer's efforts in accumulating the parcels into a unified tract. Id. at 349.

Even in the absence of substantial sales, courts have occasionally found enough activity to amount to a trade or business. See, e.g., Jersey Land & Development Corp. v. United States, 539 F.2d 311 (3d Cir. 1976) (holding that while taxpayer did not make frequent sales of its alleged inventory real estate, the gain was due to taxpayer improvements, not market appreciation, and was taxable as ordinary income).

See, e.g., Suburban, 615 F.2d at 171, which demonstrates that courts frequently decide factually indistinguishable cases inconsistently. Compare Commissioner v. Williams, 256 F.2d 152 (1958) with S & H, Inc. v. Commissioner, 78 T.C. 234 (1982).
of men for the purpose of [earning] a livelihood for profit."

Thus, an analysis of the trade or business issue under other sections of the Code reveals that the line between business and investment appears to be drawn by the element of personal services and their impact on the ultimate profit of the activity. A for-profit endeavor which depends upon substantial services for its ultimate profit would constitute a business, whereas an endeavor in which profit is derived primarily from capital appreciation is more in the nature of an investment. The extent of the activity, although a significant factor, is not determinative. Even a taxpayer, as in Whipple, who spent substantial amounts of time studying, buying and selling investment assets would be a mere investor because the profit of the endeavor depends primarily on market appreciation.

Applying the analysis to section 174, it becomes clear that the creation of technology through research and development activities with an intent to derive a profit should constitute a trade or business. Research and development activities involve labor and the expenditures of time and effort of a personal service nature in the creation of a valuable asset. These activities are far different than the investment activities described in the Whipple case and should not be characterized as such.

As the foregoing discussion indicates, substantial research and development activities conducted for profit clearly fall within the concept of a trade or business under any section of the Code, albeit the pre-opening phase of a business. The second question that must be addressed is whether a taxpayer can satisfy this requirement if all, or substantially all, of the activity is conducted by an independent contractor on behalf of the taxpayer. Clearly, if the taxpayer himself were conducting all of the research activities, those activities would be sufficient to place the taxpayer in the

75 A finding of sufficient taxpayer efforts for a trade or business, however, should not overcome the additional qualification in the context of §162 that pre-opening expenses are not deductible, and it would appear to be an unwarranted extension of the holding in the Groetzinger case to contend otherwise. Rather, pre-opening expenses represent one aspect of capitalization, which was not at issue in the Groetzinger case. One strongly suspects that the non-allowability of a current deduction for pre-opening expenses will continue to remain intact in the tax law. Nevertheless, as long as research activity would satisfy the trade or business requirement of Groetzinger, those research expenses would be deductible under §174, because §174 represents a statutory exception to the pre-opening expense limitation of §162.
pre-opening stage of a trade or business, regardless of whether the taxpayer was ever going to manufacture products. Can the activities of an independent contractor of the taxpayer also satisfy this requirement?

The Treasury's regulations in the context of section 174 answer the question affirmatively and leave no room for doubt. In contrast to the current pattern of voluminous regulations with myriads of exceptions, the regulations issued under section 174 are refreshingly clear and simple. These regulations expressly contemplate the use of research contractors to perform the research and development work for the taxpayer who is entitled to the section 174 deduction. The regulations, in part, provide as follows:

The provisions of this Section apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor).  

Although under other sections of the Code, most notably section 1221, courts often distinguish between an independent contractor and an agent based upon the degree of taxpayer control, this distinction should not be the case under section 174.

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76 Treas. Reg. §1.174-2(a)(2). See also Rev. Proc. 69-21, 1969-2 C.B. 303, and Priv. Ltr. Rul. 8,614,004 (November 25, 1985) evidencing the Service's view that, at least under §174, the activities of an independent contractor may be attributed to the taxpayer.

77 Under §1221, the taxpayer who owns land to be subdivided and who procures the services of a sales agent to sell the subdivided lots to customers will generally recognize ordinary income on the sale because the property will be regarded as held by the taxpayer for sale to customers in the ordinary course of his trade or business. The taxpayer generally cannot insulate himself from that result by using a sales agent in lieu of actively soliciting sales himself.

In Achong v. Commissioner, 246 F.2d 445, (9th Cir. 1957), the court attributed the activities of a broker to the taxpayer when the taxpayer had the right to approve the final subdivision plans and the cost of improvements. Id. at 447. In that case, lot prices were to be agreed upon by the taxpayer and the broker; the taxpayer bore all expenses of developing and improving the property; and the broker's books were open to inspection. Id. at 446. See also Biedenharn Realty Co. v. United States, 526 F.2d 409, 419 (5th Cir. 1976), cert. denied, 429 U.S. 819 (1976)(the brokers "did not so completely take charge . . . as to permit the [taxpayer] to wall itself off legally from their activities.").

78 The Tax Court in Smith v. Commissioner, 91 Curr. Tax Ct. Reg. Dec. (CCH) No. 48, Dec. 45, 110 (1988), however, recently left this question open, but suggested in an offhanded way that direct taxpayer involvement may be required under the trade or business requirement of §174, where the taxpayer's profit motive was questionable. See also Drobny v. Com-
Most of the cases under section 1221 that distinguish between an agent and an independent contractor on the basis of taxpayer control are not applicable to cases involving section 174. They can be explained by reference to the additional requirement in section 1221 that property be held for "sale to customers." To find a capital asset under section 1221, one must conclude that the customers are those of the selling agent and not the owner of the property. The amount of taxpayer control over the agent is probative of this question. The greater the owner's control, the more likely it will be that the prospective purchasers are the owner's customers.^[78]

missioner, 86 T.C. 1326, 1343-48 (1986). Both of these cases suggested the significance of direct taxpayer involvement in the context of sham transactions devoid of economic substance, indicating that lack of taxpayer control over management of the activity is a factor supporting a finding of sham, but otherwise has no impact on the technical requirements of trade or business.

^[78] In Bauschard v. Commissioner, 279 F.2d 115 (6th Cir. 1960), even though the taxpayer was totally "walled-off" from the developer, the court attributed the developer's activities to the taxpayer. Id. at 118. The taxpayer, a Catholic priest, purchased the property in issue along with the local pharmacist in order to prevent the construction of a low cost housing development in their residential community. Title to the property was taken in the name of two trustees. The trustees leased the property to a real estate developer for five years. It was understood that during the term of the lease the developer intended to subdivide and improve the property at his own expense. The trustees also granted the developer an option to purchase any or all of the lots at an undetermined price. The developer organized a corporation to which he assigned his interest in the lease. The corporation then subdivided and improved the property and solicited sales of the lots. As each lot was sold by the corporation, the trustees signed a deed and thereby transferred title directly to the purchaser. In all, there were sixty-five separate sales involving twenty-three purchasers. Id. at 117. Even though the property was under option to the developer for a fixed price, and the taxpayer had no control over the developer, the court held that the property was held by the taxpayer for sale to customers in the ordinary course of business. See id. at 118.

Interestingly, the court stated that the taxpayer's single sale argument might have merit if the option for the property as a whole had been exercised before the development and sale of the lots. See id. However, in Voss v. United States, 329 F.2d 164 (7th Cir. 1964), the taxpayer engaged a developer to subdivide a sixty-acre parcel and improve the subdivision with streets and utilities. The developer was solely responsible for marketing and selling the lots and all of the improvement expenses were paid out of the sales proceeds. The court declined to attribute the developer's activities to the petitioner because in its view the developer was an independent contractor as opposed to an agent. In so holding, the court emphasized that the developer had total discretion in setting the prices and incurring expenses. The taxpayer's only activity was to sign the deeds to transfer title. See id. at 167.

Indeed, the facts of Bauschard are analogous to the typical research and development arrangement where a taxpayer which owns rights in basic technology essentially engages an outside firm to perform further development work and grants an option to the research contractor to purchase the new developments. Under Bauschard, as long as the option is not exercised prior to the development, the activities of the contractor should be attributed to the taxpayer. Conversely, if the option is exercised and a sale takes place prior to the devel-
Furthermore, the language of the regulations clearly indicates that the activities of an independent research contractor should be attributed to the taxpayer under section 174 without regard to the degree of the taxpayer's control over the contractor. It is almost axiomatic that a taxpayer may conduct his business through an agent and nevertheless be engaged in business.\textsuperscript{80}

Indeed, the Treasury's recently issued regulations under section 355 indicate acceptance of this view. In general, section 355 permits a corporation to distribute or "spin-off" stock in an another corporation which it controls to its shareholders without recognition of gain to itself or to the recipient shareholders, if the specific requirements of the section are satisfied. One of the requirements is that both the distributing corporation and the controlled corporation must be engaged in the "active conduct of a trade or business" immediately after the distribution.\textsuperscript{81} The new regulations interpret this requirement, in part, by defining trade or business as "a specific group of activities that are being carried on by the corporation for the purpose of earning income for profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit..."\textsuperscript{82} The active conduct of a trade or business, which is the actual requirement under section 355 for tax-free treatment, provides that each corporation must not only have a trade or business, but also that "the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors."\textsuperscript{83} It follows, therefore, that the Treasury's position regarding the definition of trade or business within the meaning of section 355 is consistent with case law and permits business functions to be conducted by an independent contractor on behalf of the principal work, the activities of the "agent" are no longer on behalf of the principal and therefore cannot be attributed to the principal. The latter situation was precisely the situation in Green v. Commissioner, 83 T.C. 667, 691 (1984) and logically justifies the court's holding in that case.

\textsuperscript{80} See Reiner v. United States, 222 F.2d 770, 771 (7th Cir. 1955); Kaltreider v. Commissioner, 255 F.2d 833, 838 (3rd Cir. 1958).

\textsuperscript{81} I.R.C. §355(a)(1)(C) and (b)(1).

\textsuperscript{82} Treas. Reg. §1.355-3(b)(2)(ii).

\textsuperscript{83} Treas. Reg. §1.355-3(b)(2)(iii).
of the taxpayer.

Moreover, the recent enactment of the Tax Reform Act of 1986 confirms that an owner of a business need not be active to be engaged in a trade or business. Section 469, enacted under the Tax Reform Act of 1986, contains the passive activity loss rules which deals, in part, with the tax treatment of a taxpayer who has only minor involvement in a trade or business.\(^8\) In substance, these rules preclude a taxpayer from using losses from a passive activity ("passive losses") to offset nonpassive income. Nonpassive income includes income from salaries, investments and other sources other than from passive activities.\(^8\)

A passive activity is defined, in part, as "[a]ny activity which involves the conduct of any trade or business, and in which the taxpayer does not materially participate."\(^8\) A taxpayer is "treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is (A) regular, (B) continuous and (C) substantial."\(^8\) The section clearly contemplates, therefore, that even though an activity may be conducted on behalf of a taxpayer, if the activity constitutes a trade or business, it is sufficient to qualify the taxpayer as carrying on a trade or business.\(^8\) The entire concept upon which the passive activity loss rules are based would be meaningless if a taxpayer could be precluded from carrying on a trade or business by virtue of the taxpayer's lack of personal involvement in performing services.

**B. Application of the Suggested Analysis to a Basic Hypothetical Case**

A hypothetical case, modeled on the Green case,\(^8\) can be studied in light of the foregoing discussion of trade or business to demon-

\(^8\) I.R.C. §469.
\(^8\) I.R.C. §469(c)(1).
\(^8\) Section 469(h). It is also interesting to note that §469(c)(5) specifically includes in the term "trade or business" for purposes of the section any activity involving research or experimentation within the meaning of §174.
\(^8\) For example, the sole proprietor of a twenty-person law firm who does no legal work himself is of course engaged in a trade or business as long as he derives the profits from the firm's trade or business activities.
strate that the analysis suggested in this paper is the proper analysis. The study will demonstrate the weakness of the Service’s current position and the inexactitude of recent judicial analysis. The hypothetical will also facilitate a critical examination of the factors which recent courts have highlighted as significant in holding that research expenses were not in connection with a trade or business.

Assume a partnership (the “Partnership”) contracts with an independent contractor (the “Research Company”) to perform research for the Partnership under a research contract. Under the agreement, ownership of, and all rights to, the technology developed (the “New Technology”) by the Research Company belong to the Partnership as developed. All patents will be in the name of the Partnership.

A prospective licensee (the “Licensee”) would like to license the technology on an exclusive worldwide basis and the Partnership is well aware of this desire. Assume also that the bona fides of the research are beyond question and therefore not at issue. Finally, assume that all research expenditures by the Partnership to the Research Company are made in cash.

Under the facts of the hypothetical, the Partnership should be entitled to a current deduction under section 174 for its payments to the Research Company. This conclusion is based squarely on the Supreme Court’s holding in Snow v. Commissioner.90 The Service has indicated that it will challenge the Partnership’s research and development expenses in cases like that presented by the hypothetical as not being in connection with a trade or business.91 The Service may contend that the Partnership never “engaged in” a trade or business because it never sold physical products or actively attempted to license the New Technology to multiple licensees on a nonexclusive basis. On the contrary, by hiring the Research Company to conduct research for the creation of New Technology and intending to exploit the New Technology for profit through licensing, the Partnership would satisfy the trade or business requirement of section 174.

Nevertheless, the Service and several courts have somehow found significance in various extraneous factors present in the hy-

91 See supra notes 29 to 40 and accompanying text.
These factors include the following: (1) the general partner of the Partnership was not an inventor by trade; (2) all of the actual research work was done by an independent contractor rather than employees of the Partnership; (3) the Partnership never intended to, and indeed never did, manufacture or sell products using the technology; (4) the licensee of the technology was the same company or an affiliate of the company hired to perform the research (and, perhaps, that company was granted a *bona fide* option to license the technology); and (5) the transaction somehow appears "abusive." These factors, however, have no independent significance in the context of section 174.

(1) The General Partner Is Not an Inventor; and

(2) All of the Actual Work Is Done by an Independent Contractor.

Assume that the Partnership had hired the Research Company to perform research services for the Partnership. Developments and advances by the Research Company would be for the account of the Partnership and any patents or technology developed would belong to the Partnership. The activities of the Research Company should be imputed to the Partnership as if the general partner of the Partnership had performed that activity. Otherwise, juridical entities like partnerships and corporations could never be deemed to be engaged in a trade or business because these entities can only act through agents. Indeed, as discussed above, the Treasury regulations are abundantly clear that a taxpayer is entitled to the deduction under section 174 for amounts expended by the taxpayer for research services performed on the taxpayer's behalf. The deduction is available even if the Partnership's intention is to dispose of the technology in a one-shot transaction. The critical inquiry is the nature of the activity and not the taxpayer's personal involvement in the activity.

Reversing the situation, assume that the general partner is an inventor. Assume further that the technology has been licensed to

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**See, e.g., Levin v. Commissioner, 87 T.C. 696, 725-28 (1986), aff'd, 832 F.2d 403 (7th Cir. 1987).**

**See supra notes 28 to 39 and accompanying text.**

**See supra note 76 and accompanying text.**
the Licensee before the research has been undertaken. In this situation, the Partnership will be engaged in research activities because of the work of the general partner-inventor. The Partnership, however, will be engaging in those activities on behalf of someone else, namely the Licensee, who owns the technology as it is developed. In this capacity, the Partnership becomes similar to the Research Company in the initial hypothetical. Any expenses that the Partnership incurs will be expenses under section 162 of the Code because it will be carrying on the business of performing research for another. The nature of the activities as research in the experimental sense would be treated no differently than if the Partnership were engaged in constructing a house under contract with a customer. The research nature of the activity would be irrelevant to the Partnership's deductibility of the expenses.

Similarly, the Licensee, the company for whom the Partnership is working, has hired the Partnership to perform research activities for it. The regulations under section 174 clearly contemplate that the Licensee, having research performed on its behalf, should be entitled to the deduction under section 174 rather than being required to capitalize these expenses and add them to the basis of any technology or patent that is developed.\footnote{See id.} Section 174 is designed to provide a current deduction for expenditures that would ordinarily be capitalized under general capitalization principles or the principle of pre-opening expense.\footnote{See supra note 8 and accompanying text.} The Partnership would never be required to capitalize its costs of performing research services for another. Absent section 174, the employing company, however, would be required to capitalize those expenditures. Therefore, section 174 is available only to the employing company to convert its otherwise capitalized expenditure to a currently deductible expense.

Thus, the technical background and white lab coat attire of the general partner does not go to the question of whether the research and development expense deduction is that of the Partnership. Nor can it preserve the deduction for the Partnership if the Partnership is performing those services on behalf of someone else. It is irrelevant under section 174 that the owner of the technology is also the inventor. Hiring employees or an independent contractor
to perform research services for the owner is sufficient to entitle the partnership to the deduction for qualifying expenditures under section 174.

3. The Partnership Never Intended, and Indeed Never Did, Manufacture or Sell Products Using the Technology.

The fact that the Partnership never intended to manufacture a product with the technology is also irrelevant. As long as the Partnership does not pre-license the technology to the Licensee, either as a legal or practical matter, the Partnership should be entitled to the research and development deduction under section 174 of the Code because the research and development would be done on the Partnership's behalf. The deduction should be allowed regardless of whether the research activities were successful and the Partnership manufactures the product, whether the technology is successful and the Partnership licenses the technology to another firm to manufacture the product, or whether the research was a failure so that manufacturing was not pursued.

If the deduction hinged on whether manufacturing ultimately commenced, then only those companies that were successful in pursuing research and development would be entitled to deduct their research expenses. Start-up companies would be denied a deduction unless the technology proved economically exploitable, which is precisely what Justice Douglas was concerned about in the Snow case. Under such a construction, only well-financed companies that had ongoing sales could be assured of a deduction.

Moreover, only research performed by companies that would ultimately use the technology to manufacture products or perform services would be allowed a deduction under this restricted view of section 174. Thus, a high-tech research company that had insufficient capital to start a manufacturing facility which instead licensed its technology to large airplane or automobile manufacturers could never be allowed a section 174 deduction because it would never be in any trade or business other than conducting research.

Nor should developing the technology with the intention of granting an exclusive license after the technology was developed

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preclude a section 174 deduction on the theory that there was insufficient marketing activity. Rather, the section 174 deduction should be allowed because the Partnership is in the trade or business while the research is being conducted. The period before licensing might be considered the pre-opening phase of the trade or business. But, section 174 was designed to grant a deduction for expenses in the pre-opening phase for small companies that were not yet well established.\(^9\)

If a taxpayer's intention to exploit the technology in a particular way were relevant, at what point would one determine whether the taxpayer would use the technology in a trade or business? Would one have to wait to see whether the taxpayer ever commenced to "carry on" a trade or business before allowing the research and development deduction, even though the research expenses may have been made several years before the sales activity begins? Quite the contrary must be true. Under the annual accounting system, each year must stand on its own. It would be inconsistent with general tax accounting principles to force a taxpayer to hold open his tax year until it is certain he has commenced to "carry on" a trade or business, in the government's view, in subsequent years. The research could last four or five years, in which event the statute of limitations would have closed on the first year of research. The proper year for the deduction is the year in which the expense was paid or incurred, and there is no specific statutory provision for holding open the statute of limitations on research expenses.

Furthermore, to deny the deduction to the Partnership as the owner of the technology would preclude anyone from getting the deduction. None of the other players has any claim to it. The Research Company is simply performing services for another and the Licensee is simply purchasing technology and must capitalize its cost.\(^9\) If research is performed, a deduction under section 174 should be available, and the taxpayer on behalf of whom the re-

\(^9\) See id.

\(^9\) See Treas. Reg. §1.174-2(a)(2). See also Treas. Reg. §1.174-2(a)(3), Example (3), which provides that no deduction for research expenditures will be allowed where the taxpayer hires another to develop a specific product under a performance guarantee, since the taxpayer has not incurred any risk. For a discussion of the risk element, See Nathony, Tax Shelters and Section 174: Research and Experimental Expenditures in the Tax Shelter Context, 4 J. Tax'n Inv. 19, 27 (1986).
search is done is the most appropriate candidate to receive the
deduction.

Thus, the test of trade or business should look to who owns the
technology as the technology is developed. Unlike the Green case
and its progeny, the taxpayer in Snow owned the technology as it
was being developed and had not sold it prior to the research work
being done. In all subsequent Commissioner victories on this issue,
that was not the case.

Some courts, however, have suggested that one should look to
the taxpayer's intent as to whether they planned to enter into the
business of manufacturing products or performing services using
the technology. Such an approach would unduly restrict the con­
cept of "trade or business," in contravention of the Supreme
Court's decision in Groetzinger which rejected the requirement
that taxpayers must offer goods or services to be in a trade or
business.\(^{100}\)

4. The Licensee of the Technology is the Same Company or an
Affiliate of the Company Hired to Perform the Research.

The identity of the licensee of the technology and the person
performing the actual research work at first blush would seem to
indicate that the Partnership, situated between the two, is merely
providing financing. But, suppose the arrangement begins with the
Partnership hiring the Research Company to perform research ser­
vices. Assume also that at some time after the initial agreement,
the Research Company becomes enamored of the technology being
developed and offers to purchase the technology through a license
providing royalty payments to the Partnership. Under these cir­
cumstances, the license of the technology to the Research Com­
pany should have no effect on the initial deductibility of the re­
search and development expenditures under section 174 because at
the time these expenditures were made, they represented expenses
for research performed on behalf of the Partnership, which owned
all rights to the technology.

In this situation, there are two transactions occurring. First,
under the research contract, the Research Company performed the
research services for the Partnership for a fee. The second transac­

tion occurs under the license agreement through which the Partnership licensed the technology back to the Research Company. As long as these two transactions were separate transactions and the license agreement occurred after the technology was developed, the subsequent license agreement should have no effect on the deductibility of fees for research services paid by the Partnership.

Now, suppose that at the time the research work was being performed, the Partnership had already licensed the technology to be developed back to the Research Company. The Partnership would not be entitled to a deduction under section 174 because the Partnership never had rights to the technology and the technology was not developed on the Partnership’s behalf. This result is the holding of the Green case and the cases following Green.101

In Green and the cases which followed, the Service challenged the taxpayer’s deductions for research and development expenses because these expenditures related to a period after the date of the disposition of the inventions to the licensee.102 The courts held that the exclusive license agreement between the taxpayer and the licensee constituted a sale of those inventions. Because the sale took place before the taxpayer incurred the research and development expenditures, the research costs were not expended on the taxpayer’s behalf. Rather, the expenditures represented, in the courts’ view, an acquisition cost of the licensee’s promise to pay a stream of royalties to the taxpayer.103 All of these cases indicate that a taxpayer’s entitlement to a research and development deduction under section 174 will depend on whether that taxpayer has, in effect, sold (i.e., licensed on an exclusive basis) the technology prior to incurring the research expenses.104

In contrast, the Partnership in the hypothetical owned the new technology as it was developed. It was assigned all of the patents to the new technology as they were obtained. It had all rights to that technology, and was not obligated to license the technology to anyone. In that situation, the separate identities of the Research Company and Licensee would make it clear that the research and licensing agreements were separate transactions.

101 See supra notes 28 to 39 and accompanying text.
102 See id.
103 See id.
104 See id.
Although, as a technical matter, the identity of the Research Company and the Licensee is legally irrelevant, as a practical matter, the identity causes one to question whether the two transactions are interrelated and not separate. Assume now that the Partnership entered into the research contract with the Research Company and also granted the Research Company an option to acquire the technology in the future, after the technology was developed. The existence of the option should be irrelevant to the treatment of the expenditures unless the option is viewed, in substance, as a sale at the time of grant. The appropriateness of that view depends upon the legal and tax nature of an option.

The overwhelming case law authority holds that an option is not a sale and does not transfer ownership of the subject property for tax purposes. However, if the option were certain of being exercised, such as when the option is exercisable at a nominal price, then it would be considered a sale for tax purposes and not truly an option. Thus, as long as the exercise is not a foregone conclusion, any sale brought about by exercise of the option should be viewed as an independent transaction.

The granting of an option to license the technology to the Research Company, however, may raise practical factual questions. These factual questions can be dispelled if, during the time the technology is being developed, there are no side agreements to li-

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106 See Koch v. Commissioner, 67 T.C. 71, 88 (1976), acq. 1980-2 C.B. 1. The grantor is taxed when the option is exercised or lapses. At the time of exercise of the option, the transaction constitutes a completed sale. See Commissioner v. Dill Co., 294 F.2d 291, 300-01 (3d Cir. 1961); See Hunter v. Commissioner, 140 F.2d 954, 955 (5th Cir. 1944); Virginia Iron, Coal, Coke Co. v. Commissioner, 37 B.T.A. 195, aff'd, 99 F.2d 919, 921 (4th Cir. 1938), cert. denied, 307 U.S. 630 (1939). The principal is also followed by the Internal Revenue Service. See Rev. Rul. 58-234, 1958-1 C.B. 279; Rev. Rul. 78-182, 1978-1 C.B. 265. Moreover, even where the amount of the option payment exceeds the basis of the underlying property (so that the optionor will receive a profit in any event), the courts have consistently taken the position that the grant of the option is not a sale of the underlying property and is not a taxable event. See, e.g., Hunter v. Commissioner, 140 F.2d 954 (5th Cir. 1944); Commissioner v. Dill Co., 294 F.2d 291, 300-01 (3d Cir. 1961); Hicks v. Commissioner, 37 T.C.M.(CCH) 1540, 1546 (1978); Helmer v. Commissioner, 34 T.C.M. 727, 730-31 (1975).

106 Property Growth Co. v. Commissioner, 55 T.C.M. (CCH) 1072, 1075 (1988); Diamond v. Commissioner, 92 Curr. Tax Ct. Reg. Dec. (CCH) No. 25, Dec. 45,497 (1989)(deduction denied when option could be exercised without cost and partnership was otherwise precluded from obtaining a patent for the device developed); Moore v. Commissioner, T.C.M. 1989-38 (January 24, 1989)(Partnership denied deductions under §174 for suspect research in a transaction devoid of profit motive to the partnership and in which the option to license the resulting technology was prearranged or a foregone conclusion).
cense and the technology is exploitable by someone other than the Research Company-Licensee.

Of course, by the granting of the option, the Partnership has transferred away some of the potential upside of the transaction. The transfer of some upside potential, however, occurs in all option situations and is not unique to the research situation. The transfer of upside potential should have no effect on the availability of research and development expense deductions. The existence of the option, therefore, is legally irrelevant to an analysis of deductions under section 174.

To be sure, a form of pre-licensing may be deemed to take place without a formal license agreement if the technology to be developed was so restricted or of so limited use as to be unsalable to anyone but the prospective licensee. In that event, the ultimate licensing to the prospective licensee may be regarded as so certain as to preclude the nominal owner from having a full ownership interest in the technology. However, the prospective Licensee, which would typically be the Research Company, would not yet have the full ownership interest either. Therefore, it would be inappropriate to treat the technology as pre-licensed to that Licensee.

If it is clear at the inception of the research that the technology will not be exploitable by someone other than the Research Company-Licensee, but it has not been pre-licensed, then the relationship between the Partnership and the Research Company is best characterized as a joint venture. The allocation of deductions for research and development expenses between the Partnership and the Research Company would be governed by section 704(b) of the Code and the regulations thereunder, which, in substance, allocate the deductions on the basis of who bears the risk of economic loss from unsuccessful research. In cases in which the Partnership contributed money for the research, the Partnership would be entitled to the allocation of deductions attributable to the contributions.

The definition of a joint venture is well established in the opinions of the Tax Court. A joint venture has been defined as "a special combination of two or more persons, where in some specific venture a profit is jointly sought without any actual partnership or

107 See generally notes 102 to 104 and accompanying text.
108 I.R.C. §704(b).
corporate designation." As the Court stated in Podell v. Commissioner, the elements of a joint venture are:

(a) a contract (express or implied) showing that it was the intent of the parties that a business venture be established; (b) an agreement for joint control and proprietorship; (c) a contribution of money, property and/or services by the joint venturers; and (d) a sharing of profits but not necessarily losses.

In Bussing v. Commissioner, the taxpayer participated in a multi-party equipment leasing arrangement in which the taxpayer acquired an interest in copying equipment encumbered by a security interest and a triple net lease. The taxpayer, Bussing, paid $10,000 in cash and $31,566 in promissory notes as a downpayment with the balance of the purchase price offset by the rental income. However, Bussing was entitled to a small percentage of any sublease rents received from the seller during the last three years of any sublease. Bussing also entered into a marketing agreement appointing the seller as his agent in marketing the equipment and in daily management decisions. For these services, the seller was entitled to receive 15% of the proceeds from any sale or lease of the equipment plus marketing costs.

Under these facts, the Tax Court concluded that Bussing and his seller/agent entered into a joint venture:

The several agreements executed by and between Bussing and [the seller/agent], viewed as a whole, evidence an intent to join together in a transaction in order to share profits and losses. First, each party has contributed something of value to the venture — petitioner, his capital; AG, its services, business contacts and the equipment subject to encumbrances. Second, each party has a significant interest in the rental and residual value of the equipment. AG’s loan to Handlesbank is paid down by Continentale’s rent. AG’s “rent” to Bussing equals Bussing’s “loan” payments to AG. No losses are allocated to AG, but instead are allocated to Bussing and the other investors in accordance with the interest acquired by each. The substance of this transaction is that the parties are engaged in a joint venture — to invest in, lease and market the

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equipment.\textsuperscript{112}

If at the inception of the research the Partnership were economically but not legally compelled to enter into a license agreement pursuant to which it would share profits from the technology, but the Research Company had no right to force the Partnership to sell or license the technology, then joint venture characterization would be appropriate. The arrangement and the several agreements executed by and between the Partnership and the Research Company, viewed as a whole, would evidence an intent to join together in a transaction to share profits and losses. First, each party would have contributed something of value to the venture: as to the Partnership, capital and marketing assistance; as to the Research Company, its services, experience, and the old technology. Second, each party would have a significant interest in the successful marketing of the technology. If the Research Company exercised its option, it would benefit from the revenues generated by the sublicensing of the technology. The Partnership in turn would receive royalty payments. Thus, if the Partnership were economically compelled to license the technology to the Research Company, under \textit{Bussing} and \textit{Podell}, the Partnership and the Research Company could be viewed as having entered into a joint venture to develop and exploit the new technology.\textsuperscript{113}

In two cases under section 174, courts have addressed the issue of the conditions under which a joint venture is formed between a capital participant and a research participant. In \textit{Cleveland v. Commissioner},\textsuperscript{114} the Fourth Circuit held that a joint venture was formed upon the execution of a trust agreement. The agreement provided that (1) the inventor would devote his full time efforts to research and development; (2) the investor would contribute all of the necessary funds; and (3) that the invention was jointly owned and profits would be shared equally. The investor, Cleveland, provided capital to the venture and testified that he met weekly with the inventor to discuss the progress of the research. All of the research was performed and controlled by the inventor. Although the agreement did not purport to create a joint venture, the court held that “the effect of the contractual provisions, considered as a

\begin{footnotes}
\item[112] Id. at 461-62 (citations omitted).
\item[113] See id.; \textit{Podell}, 55 T.C. 429, 31.
\end{footnotes}
whole, is to make the parties equal participants in a joint venture.\textsuperscript{115}

In a more recent case, \textit{Green v. Commissioner},\textsuperscript{116} the Tax Court ruled on the conditions under which it would hold that a joint venture had not been formed. In contrast to \textit{Cleveland}, the investor in \textit{Green} granted an exclusive license to the research contractor contemporaneous with the research and development agreement. As a result, the capital participant never actually had ownership rights in any new technology. As the Tax Court noted:

\begin{quote}
The present case is distinguishable from \textit{Cleveland} because LaSala, unlike the joint venture in \textit{Cleveland}, had sold to NPDC all its rights to any product that might result from the research, and after the sale, LaSala, unlike the joint venture in \textit{Cleveland}, was not engaged in the business of developing the product.\textsuperscript{117}
\end{quote}

Again, it appears that the only relevant factor in determining entitlement to the section 174 deduction in the hypothetical is whether the research was done on behalf of the Partnership. None of the other factors mentioned by courts or the Service has independent significance.

5. \textit{Amorphous Feeling of Abuse of the Tax System.}

The Service apparently sees the Partnership in the hypothetical as abusive when the situation is presented in the form of a syndicated "tax shelter."\textsuperscript{118} The Service's view especially would be the case if the research services were not paid for in cash but rather were funded with a deferred payment obligation. But, consider the "abusive" tax shelter that took place in \textit{Snow}. In \textit{Snow}, research and development deductions were allowed to individuals at their relatively high rates of tax in the mid-1960s.\textsuperscript{119} But, when it came time to generate income, the parties put the technology into a corporation so that the income would be taxed at the relatively low corporate rates applicable at that time.\textsuperscript{120} This aspect of the case

\textsuperscript{115} Id. at 173.
\textsuperscript{116} 83 T.C. 667 (1984). \textit{Green} is discussed in detail at supra note 1 and notes 28 to 39.
\textsuperscript{117} Id. at 691.
\textsuperscript{118} See supra notes 28 to 39 and accompanying text.
\textsuperscript{119} The highest marginal rate of tax for individuals in 1960 was 87%. Stan. Fed. Tax Rep. (CCH) ¶152, p. 7952.
\textsuperscript{120} The highest marginal corporate rate at that time was 52%. Id. at ¶156, p. 7968.
was not discussed by any of the courts in the Snow case, and for good reason — it was irrelevant to the section 174 issue — just as the Commissioner's perception of abuse in the syndicated tax shelter context is irrelevant to the trade or business issue.

The Snow case clearly holds that research and development expenses are deductible even if incurred in the pre-opening phase of a trade or business. The Partnership in the hypothetical is in the pre-opening phase because a sufficient amount of continuous ongoing activity is being conducted on its behalf by the Research Company with the intent to earn a profit. As long as the research is done on behalf of the Partnership, none of the other factors that may be urged by the Service or referred to by courts in dicta has any independent significance.

In dealing with research and development cases, the Service appears to be overly influenced by pure revenue considerations and a dislike for tax advantaged transactions. Nonetheless, as the Tax Court has noted in another case:

[We should not disregard the existence of an asset for which Congress intended tax advantages merely because the parties attempted to maximize the advantage of those benefits for one of the parties to a transaction. (The Commissioner) should recognize that in instances where there are not shams and depreciable assets exist, some person or entity is entitled to the intended tax advantages.]

This observation is no less applicable to deductions under section 174.

V. Conclusion

The Green case and its progeny, by applying the incorrect rationale in reaching a correct result, have done the tax law a disservice. Bolstered by these cases, the Service has engaged in unauthorized "Snow removal" by ignoring the Supreme Court's position in Snow, the importance of the "on behalf of" phrase in the Treasury's own regulations and the function which section 174 performs in the tax law. Admittedly, the Service has done this in cases colored by apparently meritless research designed primarily, if not exclusively, to generate tax deductions for investors.

In adjudicating those cases, however, the Courts have failed to provide guidance for other situations. They should have looked past the cases that they were actually deciding and taken care that their opinions could not be interpreted so broadly as to cut the heart out of section 174 and the Supreme Court's interpretation of that section. This article has provided a suggested analysis of the "trade or business" issue which should allow the courts and the Service to sharpen their focus on the truly abusive aspects of cases which will arise. To proceed in any other way introduces unwarranted uncertainty to already risky business decisions involving research and development. As important, imprecise opinions also create an unhealthy climate for analyzing cases involving other tax incentive provisions.