Barrow v. Commissioner, 85 T. C. 1102 (1985)

To deduct license amortization and advertising expenses under Section 1253(d)(2), the taxpayer must be engaged in an active trade or business.

Summary

Barrow and Jackson formed Norwood Industries to license and distribute a unique cassette player. They claimed deductions for license amortization and advertising expenses related to sublicenses. The Tax Court ruled that these deductions were not allowable for 1978 because the taxpayers were not yet engaged in an active trade or business. The court also clarified that under Section 1253(d)(2), actual payment, not just accrual, is required for deductions, and nonrecourse notes can constitute payment if they are bona fide. The at-risk rules further limited the taxpayers' ability to deduct losses to the amount they had personally at risk.

Facts

In 1978, Barrow and Jackson negotiated a license with Elwood G. Norris to manufacture and distribute the Norris XLP cassette player. They formed Norwood Industries and J & G Distributing to manage the venture. Norwood sublicensed territories to Barrow, Jackson, J & G, and others. The sublicenses required payments, including cash and notes, and participation in an advertising cooperative. Barrow and Jackson claimed deductions for license amortization and advertising expenses on their 1978 tax returns but had not yet sold any products.

Procedural History

The Commissioner of Internal Revenue determined deficiencies and additions to tax for Barrow and Jackson for the years 1978-1981. The taxpayers filed petitions with the Tax Court challenging these determinations. The court heard arguments on the deductibility of license amortization and advertising expenses, the application of Section 1253, and the at-risk rules.

Issue(s)

1. Whether Barrow, Jackson, and J & G were engaged in the trade or business of distributing Norwood products during 1978?
2. Whether actual payment is a prerequisite to a deduction under Section 1253(d)(2)?
3. Whether the notes given under the sublicense agreements by Barrow, Jackson, and J & G are bona fide?
4. Whether the at-risk rules of Section 465 limit the losses deducted by Barrow and Jackson with respect to the sublicenses?

Holding

1. No, because Barrow and Jackson were not actively distributing products in 1978; their activities were preparatory.
2. Yes, because Section 1253(d)(2) requires actual payment, not mere accrual, for deductions.
3. Yes, because the nonrecourse notes were bona fide as they did not exceed the fair market value of the sublicenses.
4. Yes, because the at-risk rules limit losses to the amount Barrow and Jackson had at risk, which was primarily their cash contributions.

Court's Reasoning

The court determined that Barrow and Jackson were not in the active trade or business of distributing Norwood products in 1978 because their efforts were focused on organizing the business, not actively selling products. The court interpreted Section 1253(d)(2) to require actual payment for deductions, but found that nonrecourse notes could constitute payment if they were bona fide and not illusory. The court applied the Estate of Franklin test to determine the notes were bona fide since they did not exceed the fair market value of the sublicenses. The at-risk rules were applied to limit Barrow and Jackson's deductions to their cash contributions, as their recourse debt to Norwood was excluded due to their relationship with the corporation.

Practical Implications

This decision clarifies that taxpayers must be actively engaged in a trade or business to deduct license amortization and advertising expenses under Section 1253(d)(2). It also establishes that nonrecourse notes can be considered payment for tax purposes if they are bona fide. Practitioners must ensure clients are actively engaged in business before claiming such deductions and should carefully evaluate the nature of any debt used to finance business activities to ensure compliance with the at-risk rules. This case has implications for structuring business ventures and tax planning, particularly in licensing and distribution arrangements.