Diamond v. Commissioner, 92 T. C. 449 (1989)

For research and development expenses to be deductible under Section 174, the taxpayer must be engaged in a trade or business at some point.

Summary

In Diamond v. Commissioner, the Tax Court held that Louis Diamond, a limited partner in Robotics Development Associates, could not deduct research and development expenses under Section 174 because the partnership was not engaged in a trade or business. The court found that Robotics lacked control over the exploitation of the technology developed, as Elco Ltd. retained the option to become the exclusive licensee. This case underscores the requirement that a taxpayer must have a realistic prospect of engaging in a trade or business related to the research to claim such deductions, impacting how similar tax shelter arrangements are structured and scrutinized.

Facts

Louis Diamond was a limited partner in Robotics Development Associates, L. P. , which invested in an Israeli limited partnership, Elco R&B Associates. The project aimed to develop an arc welder with an optical seam follower. Elco Ltd. , the project's general partner, had the option to become the exclusive licensee for any resulting product, retaining significant control over the project's outcomes. Robotics contributed funds to the project, expecting to benefit from royalties or an equity interest in any future entity exploiting the technology. However, the project shifted focus to developing only the optical seam follower, and Robotics' limited partners were unwilling to provide further funding. At the time of trial, negotiations were ongoing with a Belgian firm and Elco for alternative arrangements.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Diamond's Federal income tax for 1981 and 1982, disallowing deductions for research and development expenses under Section 174. Diamond petitioned the Tax Court, which heard the case and issued its opinion in 1989.

Issue(s)

1. Whether Elco R&B Associates was engaged in a trade or business such that expenses incurred for research and development in 1981 and 1982 could be deducted pursuant to Section 174.

Holding

1. No, because Elco R&B Associates was not engaged in a trade or business. The court found that Robotics, and by extension its partners, did not have a realistic

prospect of engaging in a trade or business related to the developed technology due to Elco's control over its exploitation.

Court's Reasoning

The court relied on the principle that to deduct research and development expenses under Section 174, the taxpayer must be engaged in a trade or business at some point. It cited Green v. Commissioner and Levin v. Commissioner, emphasizing that relinquishing control over the product's development and marketing precludes the taxpayer from being engaged in a trade or business. The court noted that Elco's option to become the exclusive licensee effectively controlled the project's outcome, leaving Robotics without the ability to exploit the technology independently. The court rejected Diamond's arguments that Robotics could engage in the business through future negotiations, stating that such potential was too remote and speculative. The court's decision aligned with the Seventh Circuit's reasoning in Spellman v. Commissioner, where similar contractual arrangements prevented the taxpayer from entering the business. The court also emphasized the substance-over-form doctrine, concluding that Robotics was merely an investor without control over the project's activities.

Practical Implications

This decision clarifies that taxpayers must have a realistic prospect of engaging in a trade or business related to the research to deduct expenses under Section 174. It impacts how tax shelters involving research and development are structured, as investors must retain sufficient control over the technology's exploitation to claim such deductions. The ruling may deter similar arrangements where investors lack control, potentially reducing the attractiveness of such tax shelters. Subsequent cases like Spellman v. Commissioner and Levin v. Commissioner have followed this precedent, reinforcing the requirement for active engagement in the business. Practitioners must carefully evaluate the control provisions in partnership agreements to advise clients on the deductibility of research expenses.

