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TAX ANALYSIS OF RESEARCH AND DEVELOPMENT LIMITED PARTNERSHIPS

A Research and Development (R&D) limited partnership is a business organization formed to develop a patented or unpatented invention, process, or technology.1 Although R&D limited partnerships have existed for years, only recently have inventors and manufacturers begun using limited partnerships to raise large amounts of capital for R&D projects.2 As general partners in R&D limited partnerships, large corporations recently have raised millions of dollars to fund R&D projects.3 Corporations as general partners typically purchase the end product of a limited partnership’s R&D, thereby benefiting from the partnership’s research and development.4 Furthermore, a corporation as a general partner achieves substantial benefits without risking the corporation’s assets for the full cost of the research and development, since the limited partners in a R&D limited partnership bear the risk of potentially unsuccessful research and development.5

1. See Petillon, Research and Development Limited Partnerships, 80 PAT. AND TRADEMARK REV., 243, 243 (1982); UNIFORM LIMITED PARTNER ACT (1976) § 101(7) (limited partnership is partnership consisting of at least 1 limited partner and 1 general partner); see infra notes 19-20 and accompanying text (discussion of rights and liabilities of limited and general partners). Once a R&D limited partnership completes an invention, process or technology, the limited partnership sells the R&D product to a third party in exchange for periodic payments based on sales or a lump sum. See Petillon supra at 243. The general partner in the limited partnership is either a corporation or an individual who manages the partnership in exchange for a share of an equity interest in the partnership. See id. at 248. The actual research, however, is typically performed by a third party, the R&D contractor, who performs the research for a fee. See id. The R&D contractor can be either a profit or non-profit research firm, and the limited partners are typically passive investors with no connection with the R&D product except for the limited partner’s investment. See Birnbaum, Research Expenses Provide Current Tax Savings as Well as Result in Future Sources of Income, 30 TAX’N FOR ACCT. 46, 47 (1983). In exchange for a cash contribution, the limited partners receive a share in the partnership’s profits. See Dranginis, Tax Planning: “Tax Shelters” May Make Financing Available for Research, 5 CORP. L. REV. 344, 344 (1982).

2. See Garahan, Research & Development Limited Partnerships, NAT’L L.J., Sept. 20, 1982 at 17, col. 1 (recent publicity of highly publicized multi-million dollar R&D limited partnerships has increased R&D limited partnership’s popularity for high technology companies).

3. See id. (examples of recent multi-million dollar R&D limited partnerships). Storage Technology Corp. raised $100,000,000 through three R&D projects and Trilogy System Corp. raised $55,000,000 for a R&D project. Id. Agrigenetics Corp. of Denver raised $55,000,000 for a project through a limited partnership. See Moore, Innovators Sell Major R&D Tax Shelter, Legal Times Washington, March 22, 1982, at 1, col. 2. In the Agrigenetics limited partnership, Agrigenetics Corp. was the general partner and performed a portion of the research and development. Id. University research centers conducted the remaining research and development in the Agrigenetics limited partnership. Id.

4. See Dranginis, supra note 1, at 344 (R&D limited partnership typically sells end product to general partner).

5. See Petillon, supra note 1, at 244-45. A corporation’s borrowings could risk the corporation’s liquidity. If a corporation had $400,000 in current assets and $100,000 in current liabilities, the corporation’s debt to equity ratio would be 4:1. See E. SPILLER, FINANCIAL ACCOUNTING 564 (rev. ed. 1971) (corporation’s debt equity ratio is product of corporation’s current assets divided by corporation’s current liabilities). If, however, a corporation borrowed $100,000 to finance
A limited partnership interest in a R&D limited partnership is also an attractive investment for investors looking for a tax shelter because recent declines in the real estate market and oil and gas industry have made investments in the traditional tax shelters less profitable. Under section 174 of the Internal Revenue Code (I.R.C.) a R&D limited partnership may deduct partnerships' expenditures for research and experimentation. Since a R&D limited partnerships bear the risk of unsuccessful research and development. See Treas. Reg. § 1.174-2(b)(3). (1960). Regulation 1.174-2(b)(3) provides that when a third party conducts research and development on behalf of a taxpayer, the taxpayer, under I.R.C. § 174 may deduct payments made to the third party only if the taxpayer bears the economic risk of unsuccessful research and development. Id.; I.R.C. § 174 (1976) (taxpayer may deduct research or experimental expenditures). Commentators suggest that if a R&D limited partnership enters into any arrangements with either the general partner or the R&D contractor that reduce the limited partnership's financial risk, then the R&D limited partnership may be prohibited from deducting third party R&D expenses under I.R.C. § 174. See Bettner, Change in Accounting for R&D Tax Shelter Could Cause Some Company's to Drop Deal, Wall Street Journal, February 1, 1982, at 44, col. 1. The Securities and Exchange Commission (S.E.C.) asserts that the money most large R&D limited partnerships raise is actually a loan by the limited partners to the general partner. Id. The S.E.C. noted that corporate general partners typically transfer the general partner's corporate stock to the limited partners regardless of the R&D project's success. Id.; see Financial Accounting Standards Board, Research and Development Arrangements, Exposure Draft, April, 1982, at 6 (for accounting purposes if general partner has obligation to repay limited partners then general partner must treat money invested by limited partners as loan). 6. See Garahan, supra note 2, at 17 (formerly real estate and oil and gas tax shelters represented 80% of available tax shelter offerings); see also R. Haft & F. Fass, Tax Sheltered Investments, §§ 4.01 & 7.0 (1983) (discussion of tax consequences of real estate and oil and gas tax shelters).

7. See I.R.C. § 174 (1976) (taxpayer may deduct research and experimental expenditures paid or incurred in connection with taxpayer's trade or business); Treas. Reg. § 1.174-2(a)(1) (1960) (research or experimental expenditure means in the "experimental or laboratory sense"). I.R.C. § 174 first appeared in the 1954 Internal Revenue Code. I.R.C. § 174 (1954); see Comment, Research and Development Expenditures—Section 174 Distinguished from Section 162, 40 Mo. L.R. 685, 686 (1975) (discussion of § 174 liberal standard for deductions) [hereinafter cited as R&D Expenditures]. Under the 1939 Code a taxpayer could deduct R&D expenditures only under § 23(a)(1). I.R.C. § 23(a)(1) (1939); see R&D Expenditures, supra at 687 (discussing the Court's reasoning in Snow); infra notes 57-66 and accompanying text (discussion of Snow case). Section 23(a)(1) was the predecessor of § 162 of the 1954 code. R&D Expenditures, supra, at 685. Section 162 of the 1954 Code required that business expenses be "ordinary and necessary" to be deductible. Id.

Under § 174, R&D limited partnerships may deduct only those expenses the taxpayer incurs exclusively and directly for research and experimentation. See Rev. Rul. 75-122, 1975-1 C.B.87; I.R.C. § 174 (1976) (allowing deduction for R&D expenses). In Revenue Ruling 75-122 the I.R.S. stated that, although a mining company could deduct its expenditures for developing new prototype mining equipment under § 174, the company could not deduct under § 174 expenditures for production facilities that the company did not use exclusively for research activities. Id. at 88. Furthermore, the I.R.S. held that an advertising agency could not deduct under § 174 expenditures for developing new marketing techniques because those expenditures were related to advertising and promotion and not to developing or improving property. See Rev. Rul. 71-363, 1971-2
partnership generally does not earn income until the R&D product is sold, the R&D limited partnership's deductions under section 174 will cause the partnership to show a loss during the years that the limited partnership develops the product. Investors, as limited partners in the R&D limited partnership, may deduct from gross income on their individual tax returns their pro rata share of the limited partnership's loss. Furthermore, the Internal Revenue Service (I.R.S.) grants partners long term capital gains treatment on the partner's pro rata share of the R&D limited partnership income.

Typically, a R&D limited partnership consists of a promoter, a R&D contractor, and a group of investors. The promoter is usually an investor who transfers to the partnership all rights in an idea in exchange for an interest in the limited partnership as a general partner, while the investors contribute cash in exchange for interests as limited partners. The R&D contractor performs the actual experimentation in exchange for a fee. Upon successful completion of the project, the R&D limited partnership is expected to sell its product, and the investors will share in the profits.


8. See I.R.C. § 165 (1982) (taxpayer may deduct all uncompensated losses occurring during tax year); Garahan, supra note 2, at 18 (loss deduction provides investors deduction of up to 90% of initial investment in first year). If a R&D limited partnership which consisted of 10 limited partners each investing $12,000 paid $100,000 to a R&D contractor and the limited partnership had no other expenses or income in that year each limited partner could deduct $10,000 under § 165 as their pro rata share of the limited partnership's loss. See infra note 9 (discussion of partnership taxation).

9. See I.R.C. § 165 (1982) (allows taxpayers deduction for all noncompensated losses occurring during tax year). Under the limited partnership form of organization the individual partner and not the partnership is the taxable entity. I.R.C. § 701 (1976). The partnership files an information return that computes the partnership's taxable income and the individual partner's pro rata share of the partnership's income. Id. § 6031. The partnership's information return must reflect the partnership's expense deductions. Id. If, however, as a result of the partnership's R&D expense deductions the partnership shows a loss, the taxpayer may deduct his pro rata share of the partnership's loss on the taxpayer's individual tax return. See id. § 702(a)(8) (taxpayers must take into account taxpayer's pro rata share of partnership's taxable income or loss in computing taxpayer's individual return). See also 1 W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 9.02 at p9-7, 9-8 (1977) (discussing the conduit theory of partnership taxation).

10. See Petillon supra note 1 at 254 (sale of R&D product may qualify for capital gains treatment under I.R.C. §§ 1235, 1231, or 1221); I.R.C. § 1235 (1976) (capital gains provision for sale of patents); I.R.C. § 1231 (1976) (capital gains provision for sale of property taxpayer uses in trade or business); I.R.C. § 1221 (1976) (capital gain provision for sale of capital assets); infra text accompanying notes 37-57 (discussion of availability of capital gains treatment on R&D limited partnership's income).

11. See Dranginis, supra note 1, at 344 (R&D limited partnership consists of inventors or promoters, investors, and R&D contractor); Petillon, supra note 1, at 248-49 (R&D limited partnership consists of individual or corporate general partner, investors, and R&D contractor).

12. See Dranginis, supra note 1, at 344 (general partner transfers all rights in concept or unfinished product to limited partnership); Petillon, supra note 1, at 248 (investors contribute cash in exchange for limited partner's interest).

13. See Petillon, supra note 1, at 248. Often a R&D contractor is a manufacturer or subsidiary of a manufacturer who will produce and market the end product. Id. The R&D contrac-
pletion of the R&D project, the limited partnership usually sells the product of the research and development to either the general partner or the R&D contractor.\textsuperscript{14} The R&D limited partnership generally receives, in exchange for the limited partnership’s rights in the product, periodic payments based on the R&D product’s sales.\textsuperscript{15}

In addition to the potential economic return from a successful R&D project, a R&D limited partnership has two major advantages for a promoter.\textsuperscript{16} First, by becoming a general partner in a R&D limited partnership, a small corporation can finance a R&D project without selling corporate stock or borrowing money to raise capital.\textsuperscript{17} Second, a limited partnership organization permits a promoter, as general partner, to maintain managerial control over a product’s development.\textsuperscript{18} In a limited partnership the general partner has complete managerial control.\textsuperscript{19} A limited partner, however, can not participate in the day to day affairs of the partnership.\textsuperscript{20} A R&D limited partner-

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\item \textsuperscript{14} See Dranginis, supra note 1, at 344 (general partner typically purchases R&D product for consideration based on product’s sales); Petillon, supra note 1, at 248 (R&D contractor often markets and sells R&D product).
\item \textsuperscript{15} See Dranginis, supra note 1, at 344 (limited partnership typically receive a lump sum or payments contingent on product’s sales); see also note 3 (Agrigenetic as both R&D contractor and general partner intended to purchase R&D product from limited partnership).
\item \textsuperscript{16} See Petillon, supra note 1, at 244-45 (R&D limited partnership enables corporate general partner to fund R&D project without sacrificing corporation’s liquidity or control); supra note 5 (discussion of liquidity).
\item \textsuperscript{17} See Petillon, supra note 1, at 244-45 (corporate general partner’s use of R&D limited partnership neither dilutes corporation’s equity nor risks corporation’s liquidity). The sale of corporate stock dilutes shareholder’s equity by decreasing the original shareholder’s proportional ownership interest. \textit{Id.} See SPILLER, supra note 5, at 434-447 (discussing the effect on stockholder’s equity of issuance of new stock); see also supra note 5 (discussion of effect of borrowing on corporation’s liquidity).
\item \textsuperscript{18} See Petillon, supra note 1, at 244 (corporate general partner’s use of R&D limited partnership enables corporation to maintain managerial control of project). A promoter of a R&D project in a partnership could lose control of the product’s development because all partners have equal rights in the management of the partnership. \textit{See Uniform Partnership Act \textsuperscript{18}(e) (1914) (all partners in partnership have equal rights in partnership’s management).} A promoter of a R&D project as a corporation could lose control of a product’s development because the directors manage the corporation’s business affairs. \textit{See Model Business Corporation Act \textsuperscript{35} (1982) (board of directors shall manage business affairs of corporation); id. at \textsuperscript{35} (shareholders shall elect board of directors).}
\item \textsuperscript{19} See, \textit{e.g.}, Tracy v. Tuffy, 134 U.S. 206, 224 (1890) (under Texas law only general partners in limited partnership may transact business for partnership); Palmer v. Fuqua, 641 F.2d 1146, 1155 (5th Cir. 1981) (general partner in limited partnership has exclusive power and authority to manage partnership); Donroy Ltd. v. United States, 301 F.2d 200, 204 (9th Cir. 1962) (limited partner may not control conduct of limited partnership’s business); \textit{see Uniform Limited Partnership Act \textsuperscript{403} (1976) (general partner in limited partnership has same rights, powers, liabilities of partner in partnership without limited partners); Uniform Partnership Act \textsuperscript{18}(e) (1914) (partner has right to share equally in partnership’s management).}
\item \textsuperscript{20} See, \textit{e.g.}, Van Arsdale v. Claxton, 391 F. Supp. 538, 540 (S.D. Cal. 1975) (limited partner destroys personal liability when limited partner becomes involved in partnership’s business); Bergeson v. Life Ins. Corp., 170 F. Supp. 150, 159 (D. Utah 1958) (limited partner assumes
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ship, therefore, can provide financing for a corporation's R&D project without the corporation sacrificing the control of either the corporation or the R&D project. If the R&D limited partnership chooses to employ a R&D contractor, the limited partnership, for tax purposes will usually pay the R&D contractor in advance. A cash method limited partnership can take a current deduction under I.R.C. section 174 for the prepayment to the R&D contractor if the prepayment is not a deposit and if the prepayment does not materially distort the taxpayer's income. As long as a cash method limited partnership's payp-
ment to the R&D contractor is nonrefundable the courts will not characterize the prepayment as a deposit.\(^5\) If a court characterizes a limited partnership's prepayment as a deposit, then the partnership may not deduct the amount prepaid as an expense until the prepayment's recipient spends the money.\(^2\)

Even if a limited partnership's prepayment to a R&D contractor is nonrefundable, a court may disallow the partnership's current deduction if the prepayment materially distorts the limited partnership's income.\(^2\) I.R.C. § 446(B) permits the Commissioner of the I.R.S. to require a taxpayer to change his method of accounting to a method that clearly reflects the taxpayer's income.\(^2\) The Commissioner's discretion under section 446(B) covers the accounting treatment of both individual items as well as the taxpayer's overall accounting method.\(^2\) If, therefore, the Commissioner asserts that a limited

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25. See e.g., Keller v. Commissioner, 79 T.C. 7, 36 (1982) (taxpayer could not deduct prepaid oil drilling expenses because payments were refundable); Lillie v. Commissioner, 45 T.C. 54, 63 (1965) (taxpayer could only deduct nonrefundable portion of prepaid cattle feed expenses), aff'd per curiam, 307 F.2d 562 (9th Cir. 1966); Ernst v. Commissioner, 32 T.C. 181, 186 (1959) (poultry farmer could deduct prepayments to grain dealer that were irretrievably out of farmer's pocket).

26. See Birnbaum, supra note 1, at 48 (I.R.S. is likely to question R&D limited partnership's prepaid R&D expense deduction); Petillon, supra note 1, at 252 (I.R.S. may require R&D limited partnership to amortize nonqualifying prepaid expense payments).

27. See, e.g., Burck v. Commissioner, 533 F.2d 768, 769 (2d Cir. 1976) (court required cash method taxpayer to accrue prepaid interest payment made on December 29th), aff'd, 63 T.C. 56 (1975); Bernard Resnik v. Commissioner, 66 T.C. 74, 82 (1976) (partnership's deduction for interest prepaid four years in advance materially distorted partnership's income), aff'd, 555 F.2d 634 (7th Cir. 1977); Andrew Sandor v. Commissioner, 62 T.C. 469, 483-84 (1974) (cash method taxpayer denied current deduction for interest prepaid 5 years in advance), aff'd, 536 F.2d 874 (9th Cir. 1976).

28. See I.R.C. § 446(b) (1983). I.R.C. § 446(b) provides that if a taxpayer's method of accounting does not clearly reflect the taxpayer's taxable income, the Treasury Secretary can require the taxpayer to change the taxpayer's accounting method to one that clearly reflects the taxpayer's income. Id.

29. See I.R.C. § 446(b) (1976) (Secretary can require taxpayer to use accounting method which clearly reflects income); Treas. Reg. § 1.446(b) (1973) (accounting method includes tax-
partnership's prepaid expense deduction materially distorts the partnership's income, the Commissioner will require the partnership to take the expense deduction only after the R&D contractor spends the money.\textsuperscript{30}

Regardless of whether the Commissioner requires a R&D limited partnership to deduct the partnership's R&D payments contemporaneously with the R&D contractor's expenditures, I.R.C. § 461 requires a taxpayer to take deductions in the proper tax year.\textsuperscript{31} Courts have applied a one-year rule in interpreting section 461 that states that a taxpayer may take a current deduction for a prepaid expenditure if the expenditure creates an asset having a useful life of less than one year.\textsuperscript{32} Therefore, unless under section 466(B) the Commissioner permits otherwise, a R&D limited partnership can deduct a prepayment to a R&D contractor only if the R&D contractor expends the prepayment within twelve months of the date of prepayment.\textsuperscript{33}

In addition to the available deduction for prepayment to the R&D contractor, a further advantage to an investor in a R&D limited partnership is the ability under either I.R.C. § 1235, § 1231, or § 1221 to receive long term capital gains treatment on the income arising from the sale of the R&D product.\textsuperscript{34} I.R.C. § 1235 states that the transfer either of substantially all rights

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  \item See Birnbaum, supra note 1, at 48 (under § 446(b) I.R.S. may require taxpayer to match expenses with future revenues).
  \item See I.R.C. § 461 (1976) (taxpayer must take deductions and credits in proper tax year).
  \item See Commissioner v. Van Raden, 650 F.2d 1046, 1050 (9th Cir. 1981) (one year rule applied to prepaid feed expense); Zaninovich v. Commissioner, 616 F.2d 429, 432 (9th Cir. 1980) (one year rule applied to prepaid rent expense); Bell v. Commissioner, 13 T.C. 344, 348 (1949) (one year rule applied to prepaid insurance expense). Under the one year rule a cash method taxpayer may deduct a prepaid expense if the prepayment creates an asset with a useful life of less than 1 year. See Zaninovich, 616 F.2d at 432 (prepaid lease term extended eleven months beyond year of payment). The Supreme Court in Hillsboro Nat'l Bk. v. Commissioner, cited Zaninovich with approval on an analogous issue. 103 S. Ct. 1134, 1144 (1983); Zaninovich, 616 F.2d at 432. The Tax Court in Keller v. Commissioner, however, noted that the Tax Court need not decide whether the court would adopt the one year rule expressed in Zaninovich. See Keller v. Commissioner, 79 T.C. at 40 n.24; Zaninovich, 616 F.2d at 432; see also Treas. Reg. 1.461-1(a) (1967) (cash method taxpayer shall deduct expenses in year of payment). Treas. Reg. 1.461-1(a) provides that if an expenditure results in the creation of an asset having a useful life substantially beyond the taxable year in which made, the taxpayer may not deduct or may only partially deduct the expenditure. Id.
  \item See supra notes 27-30 and accompanying text (discussion of Commissioner's authority to require taxpayer to adopt accounting method which clearly reflects income).
  \item See I.R.C. § 1235 (1976) (capital gains treatment on income from certain sales and exchanges of patents); id. at § 1231 (capital gains treatment on sales and exchanges of property taxpayer uses in trade or business); id. at § 1221 (capital assets are property which is neither inventory nor used in taxpayers trade or business); Birnbaum, supra note 1, at 48 (R&D limited partnership's income may qualify for long term capital gain treatment under § 1221, § 1231, or § 1235). If the income from a taxpayer's investment qualifies for long term capital gains treatment, the taxpayer can deduct from the taxpayer's taxable income 60% of the income that the
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in a patent or any undivided interest in a patent is a sale or exchange of a capital asset held for more than one year.\textsuperscript{35} In order for the limited partners to receive long term capital gains treatment, the R&D product must be patentable, and the individual limited partners must be holders of the patent.\textsuperscript{36}

If a R&D limited partnership does not qualify for long term capital gains treatment under § 1235 and the limited partnership's R&D product is property the limited partnership uses in its trade or business, then the limited partnership may qualify for capital gains treatment under I.R.C. § 1231.\textsuperscript{37} Section 1231 provides that a taxpayer's sale or exchange of capital assets that the taxpayer used in the taxpayer's trade or business and that the taxpayer held for more than one year qualify for long term capital gain treatment.\textsuperscript{38} For a R&D limited partnership's R&D product to qualify as property used in the taxpayer's trade or business, the R&D product must be depreciable property\textsuperscript{39} held for more than one year but not offered for sale in the R&D limited partnership's ordinary course of business.\textsuperscript{40}

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\textsuperscript{35} See I.R.C. § 1202(a) (1976) (individual taxpayer may deduct 60% of taxpayer's net capital gain from taxpayer's gross income); id. § 1222 (11) (1976) (net capital gains are excess of taxpayer's net long-term capital gains over taxpayer's net short-term capital losses); id. § 1222(7) (net long-term capital gains are excess of the taxpayer's long-term capital gains over the taxpayer's long-term capital losses); id. § 1222(d) (net short-term capital loss are excess of the taxpayer's short-term capital loss over taxpayer's short term capital gains). Whether a capital gain or loss is short term or long term depends on whether the taxpayer held the capital asset more than one year before, disposing of the capital asset. See id. § 1222(1)-(4) (if taxpayer holds capital asset more than one year, then gain or loss is long term and if taxpayer holds capital asset less than one year then gain or loss is short term).

\textsuperscript{36} See id. at § 1235(a)-(b). I.R.C. § 1235(b) defines a holder as any individual whose efforts created the property, or any person who purchased an interest in the property from the property creator before the creator marketed or patented the product. Id. Section 1235(b) excludes the property creator's employer or any person related to the property creator from the definition of a holder. Id. Under I.R.C. § 1235(d), a person is related to the creator if the person is a member of the property creator's family. Id. § 1235(d). The definition of a holder also excludes a corporation in which the property's creator owns directly or indirectly a 25% share. Id.; see Treas. Reg. § 1.1235-2(d)(2) (1980). Treas. Reg. § 1.1235-2(d)(2) states that although a partnership cannot be a holder, each individual member of the partnership may qualify as a holder in proportion to the member's interest in the patent. Id. Treasury regulation 1.1235(2)(d)(2) also provides that corporations may not be holders, but that the existence of corporate limited partners in a limited partnership does not prevent individual limited partners from qualifying as holders. Id. The R&D limited partnership need not wait until the partnership obtains a patent to qualify for § 1235 treatment. See Treas. Reg. 1.1235-2(a) (1980) (not necessary that patent or patent application exist if other requirements of § 1235 are met).

\textsuperscript{37} See I.R.C. § 1231 (1976) (taxpayer allowed long term capital gains treatment of income received from sale or exchange of property taxpayer uses in trade or business); Petillon, supra note 1, at 254 (R&D limited partnership's income may qualify for capital gains treatment under § 1231).

\textsuperscript{38} I.R.C. § 1231(a) (1976).

\textsuperscript{39} See id. at § 167(a) (taxpayer may deduct reasonable depreciation for wear and tear on property taxpayer used in trade or business, and on property taxpayer held for production of income); Treas. Reg. 1.167(a)-3 (1960) (taxpayer may only depreciate those assets that have recognizable and limited useful life).

\textsuperscript{40} See I.R.C. § 1231 (1976) (property taxpayer uses in trade or business that is not inventory and that taxpayer holds more than one year qualifies for capital gain treatment under §
A patent can qualify as property used in the taxpayer's trade or business, since a patent is depreciable property. Whether a R&D limited partnership is in the business of selling patents, however, is a question of fact. Courts will look to the continuity and regularity of the taxpayer's patent transactions in determining whether the taxpayer is in the trade or business of selling patents. A R&D limited partnership that continuously sells patents to a regular group of buyers is in the trade or business of selling patents. The income a partnership receives from isolated sales of patents, consequently, would qualify for capital gains treatment under section 1231 because the income would be incidental to the partnership's actual trade or business of performing research and development. A R&D limited partnership formed to develop and sell...
a particular product or technology therefore, may treat the income from the sale of the patent as a long term capital gain. The courts and the Commissioner, however, may characterize a R&D limited partnership that develops and sells several unrelated patents as in the business of selling patents and require the partnership to treat the income the partnership receives from the patent’s sale as ordinary income.

If a R&D limited partnership does not qualify for capital gains treatment under sections 1235 or 1231, sections 1221 and 1222 of the I.R.C. allow a taxpayer capital gains treatment on the sale of capital assets. I.R.C. § 1221 defines capital assets as property that a taxpayer neither holds as inventory nor uses in the taxpayer’s trade or business. Section 1222 provides that a taxpayer must hold a capital asset for more than one year in order to qualify for long term capital gains treatment. Whether an asset is a section 1231 asset or a section 1221 asset depends on whether the taxpayer is using the asset in the taxpayer’s trade or business. The distinction between whether a R&D limited partnership’s patents are section 1221 capital assets or section 1231 assets is important only if the taxpayer has other sales or exchanges of section 1231 assets that must be offset against the sale of the patents. For example, if a R&D limited partnership sold other section 1231

46. See I.R.C. § 1231 (1976) (qualifications for capital gain treatment on sale of property taxpayer uses in trade or business). Even if taxpayer sells several patents, the taxpayer is not in the trade or business of selling patents if all the patents the taxpayer sells are for one invention. See Beach v. Shaughnessy, 126 F. Supp. 771, 774 (N.D.N.Y. 1954) (taxpayer qualified for capital gains treatment on income from transfer of 13 patents all of which applied to one fire alarm system); Kronner v. United States, 110 F. Supp. 730, 732 (Ct. Cl. 1953) (although taxpayer owned patents on four different inventions, taxpayer qualified for capital gains treatment on sale of only marketable patent); United States v. Borton, [1950] U.S. Tax Cases (CCH) 9276, at 12,677 (taxpayer’s acquisition and transfer of two patents was incidental to taxpayer’s trade as tool manufacturer); see also supra note 42 (cases holding that taxpayer’s sale of capital asset was incidental to taxpayer’s trade or business).

47. See supra notes 41-46 and accompanying text (discussion of requirements of I.R.C. § 1231).

48. See I.R.C. § 1221 (1976) (capital asset is property taxpayer holds that is neither inventory nor property used in trade or business); id. at § 1222 (long term capital gains arise from sales or exchanges of capital assets that taxpayer held over one year).

49. Id. at § 1221(1) & (2).


51. See I.R.C. § 1231 (1976) (taxpayer must use property in taxpayer’s trade or business for property to qualify as § 1231 property); I.R.C. § 1221 (1976) (§ 1221 specifically excludes from definition of capital asset property taxpayer uses in taxpayer’s trade or business); Treas. Reg. 1.1221.1(b) (1975) (property taxpayer holds for production of income but does not use in trade or business is § 1221 capital asset); see also Gamble v. Commissioner, 68 T.C. 800, 811 (1977) (taxpayer’s sale of racehorse was sale of § 1231 asset and not § 1221 capital asset). In Gamble, the Tax Court held that the taxpayer purchased a pregnant broodmare as part of the taxpayer’s horse breeding business. Id. The Gamble court rejected the taxpayer’s assertion that the taxpayer was holding the broodmare as an investment. Id.

52. See E. Colson, FEDERAL TAXATION OF SALES, EXCHANGES AND OTHER TRANSFERS 84 (1971) (distinction between § 1231 assets and § 1221 capital assets is that taxpayer uses § 1231 assets in trade or business). Under § 1231 taxpayer must compute the net amount the taxpayer gained or lost on all sales and exchanges of § 1231 assets. Id; see infra note 55 (characterization
property besides patents for a loss in the same year in which the R&D limited partnership sold a patent that was section 1231 property, then the loss on the sale of the section 1231 non-patent property would be offset against the gain on the sale of the patent.\textsuperscript{53} A R&D limited partnership, however, would prefer that the patent be a section 1221 asset, because the gain from the sale would be a capital gain and the loss from the sale of the other section 1231 asset would be deductible from the partnership’s ordinary income.\textsuperscript{54}

Regardless of whether investors can structure a R&D limited partnership that will meet the I.R.C.’s requirements and qualify for the available tax advantages, the investor may lose these tax advantages if the federal courts determine that a R&D limited partnership serves no legitimate business purpose.\textsuperscript{55}

\textsuperscript{53} See Colson, supra note 52, at 85 (discussing effect on taxpayers gross income of treating house as either capital asset or a § 1231 asset). If a R&D limited partnership realized a $10,000 gain on the sale of a patent the taxpayer held for more than one year, and the R&D limited partnership incurred a $6,000 loss on the sale of the partnership’s equipment, the classification of the patent as a capital asset or § 1231 property would effect taxpayer’s taxable income. \textit{Id.}; see I.R.C. § 1231 (1976) (taxpayer must include in gross income net amount received from all exchanges in § 1231 assets). If the patent were a capital asset, the $10,000 gain would be a long term capital gain and the taxpayer could deduct the $6,000 loss from gross income. See Colson, supra note 52, at 85; \textit{see also} I.R.C. § 1231 (1976) (taxpayer deducts net losses of § 1231 assets directly from ordinary income). If the patent were a § 1231 asset, the taxpayer would subtract the $6,000 loss from the $10,000 gain and the taxpayer would only have a $4,000 long term capital gain. See Colson, supra note 52, at 85; \textit{see also} I.R.C. § 1231 (1976) (in determining capital gain on sale of § 1231 assets taxpayer must include net amount received from all exchanges in § 1231 assets).

\textsuperscript{54} See I.R.C. § 1221(2) (1976) (code excludes from definition of capital asset property taxpayer uses in trade or business); I.R.C. § 1231 (1976) (§ 1231 assets are property taxpayer uses in trade or business); Colson, supra note 52, at 85 (discussing differences in tax treatment of amount received from sale of asset under either § 1221 or § 1231).

\textsuperscript{55} See, e.g., Knetsch v. United States, 364 U.S. 361, 362-69 (1960) (taxpayer not permitted interest deduction when sole purpose of taxpayer’s borrowing was generation of interest deduction); Higgins v. Smith, 308 U.S. 473, 475 (1940) (taxpayer’s deduction denied for loss arising from transaction between taxpayer and taxpayer’s wholly owned subsidiary); Six Seam Co. v. United States, 524 F.2d 347, 356 (6th Cir. 1975) (parent corporation’s sale of equipment to wholly owned subsidiary was sham since subsidiary paid for equipment with proceeds from subsidiary’s sale of own stock to parent corporation); Goldstein v. Commissioner, 364 F.2d 734, 742 (2d. Cir. 1966) (taxpayer denied deduction for interest paid on bank loan when taxpayer had no realistic expectation of economic profit from transaction); Helliwell v. Commissioner, 77 T.C. 964, 990 (1981) (motion picture production company limited partnership was sham); \textit{see also infra} notes 70-91 and accompanying text (discussion of \textit{Helliwell} case); notes 92-106 and accompanying text (discussion of \textit{Knetsch} case); Gregory v. Helvering, 293 U.S. 465, 468-70 (1935). In Gregory, the taxpayer attempted to diminish the amount of income tax due on the sale of corporate stock by a reorganization of the taxpayer’s corporation. \textit{Id.} The Court held that taxpayer’s plan of reorganization served no business purpose aside from the plan’s true character as a means of transferring corporate stock to the taxpayer. \textit{Id.} The \textit{Gregory} Court held that taxpayer’s transaction was not a reorganization within the meaning of the statute that exempted gains from the transfer of stock pursuant to a plan of reorganization. \textit{Id.}; \textit{see also} 26 U.S.C. § 2112(g), (i)(1) (1928) (reorganization means transfer of assets between two corporations when same shareholders control both corporations).
If the form of a business arrangement serves no legitimate business purpose and merely serves as a tax avoidance scheme, the federal courts and the I.R.S. will consider the arrangement a sham transaction. The leading case supporting the legitimacy of R&D limited partnerships is *Snow v. Commissioner*. Although the petitioner in *Snow* was a limited partner in a R&D limited partnership, the *Snow* court did not examine whether a R&D limited partnership was a sham transaction. In *Snow*, the Commissioner denied a limited partner's deduction for the limited partner's pro rata share of the limited partnership's net operating loss for 1966. The limited partnership had a net operating loss because the partnership did not receive sufficient income to offset the limited partnership's research or experimental expenditure deduction under section 174. The Tax Court upheld the Commissioner's denial of the petitioner's loss deduction, stating that the limited partnership did not incur research and experimental expenses in connection with the limited partnership's trade or business. The Tax Court held that a taxpayer may deduct research and development expenses under section 174 if the expenses are incurred either in developing and improving existing products or in developing new products in connection with the taxpayer's existing trade or business. The Supreme Court, however, reversed the Tax Court's decision because the Supreme Court held that the purpose of section 174 was to dilute the trade or business requirement of section 162. Absent section 174, taxpayers could only deduct R&D expenditures under section 162, which permits a deduction for expenses the taxpayer incurred in carrying on the taxpayer's trade or business. The Supreme Court held that the language of section 174 allowing taxpayers to deduct research and development expenses incurred in connection with the taxpayer's trade or business was an indication that Congress intended section 174 to have a more liberal trade or business nexus requirement than section 162. The *Snow* Court concluded that a taxpayer need not

56. *See supra* note 55 (discussion of cases where taxpayer's transaction exalted form over substance).


58. *Id.* at 501.

59. *Id.*

60. *Id.*

61. *Id.*


63. 416 U.S. at 504; *see I.R.C.* § 162 (1976). Under I.R.C. § 162 only ongoing businesses may take a deduction for business expenses. *See I.R.C.* § 162 (1976) (permitting deduction for taxpayer's trade or business expenses). *See also* James D. Protsiva, 29 TCM 1318, 1321 (CH 1970) (taxpayer could not deduct expenses incurred in obtaining broadcast license because taxpayer was not yet in broadcasting business); Morton Frank, 20 T.C. 511, 515 (1953) (taxpayer could not deduct travel expenses and legal fees incurred in searching for newspaper business to purchase since taxpayer was not yet in newspaper business); *R&D Expenditures, supra* note 7, at 687 (discussing standard for deductions under § 174 and § 162).

64. *See I.R.C.* § 162 (1976) (taxpayer may deduct all ordinary and necessary expenses taxpayer incurred in carrying on taxpayer's trade or business); *see infra* note 65 (discussion of requirement that taxpayer incur expenses in carrying on taxpayer's trade or business).

65. *See* 416 U.S. at 503. In *Snow*, the Supreme Court held that a taxpayer could deduct experimentation expenses if the taxpayer incurred the expenses in connection with the taxpayer's
be currently engaged in a trade or business to deduct R&D expenses because Congress intended I.R.C. § 174 to provide an economic incentive for growing businesses to engage in research and development and to create new products and inventions.66

The Snow Court's decision encourages the growth of R&D limited partnerships by permitting taxpayers to deduct R&D expenses that taxpayers incur in preparing to begin a trade or business.67 Furthermore the treasury regulations accompanying section 174 encourage the growth of R&D limited partnerships by permitting taxpayers to deduct under section 174 amounts paid to third parties to conduct research and development on the taxpayer's behalf.68 The Snow decision and the treasury regulations, therefore, permit a limited partnership consisting of passive investors to take a deduction under section 174, even though the partnership does not intend either to perform the research or market the end product.69

Although the Snow decision and the regulations accompanying section 174 have encouraged the growth of R&D limited partnerships, neither the.

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67. See Petillon, supra note 1, at 244 (Snow decision confirmed tax advantages available to R&D limited partnerships); R&D Expenditures, supra note 7, at 687 (discussing effect of Snow decision on R&D expense deductions).

68. See Treas. Reg. § 1.174-2(a)(2) (1960). Treasury Regulation § 1.174-2(a)(2) provides that § 174 applies to amounts a taxpayer pays to a third party for the third party to conduct research and development on the taxpayer's behalf. Id.; see e.g., Rev. Rul. 73-324, 1973-2 C.B. 72 (natural gas company could deduct under § 174 payments made for research and development that natural gas trade association and Department of Interior jointly conducted); Rev. Rul. 73-20, 1973-1 C.B. 133 (domestic utility could deduct payments to nonprofit trade association engaged in R&D project); Rev. Rul. 69-484, 1969-2 C.B. 38 (commercial airline could deduct payments to aircraft manufacturer for R&D work on supersonic aircraft).

69. See Snow 416 U.S. at 504 (taxpayer does not have to be currently in trade or business to deduct R&D expenses under § 174); Treas. Reg. § 1.174-2(a)(2) (1960) (taxpayer may deduct amounts paid to third parties who conduct research and development on taxpayer's behalf); see also Birnbaum, supra note 1, at 47 (passive investors as limited partners may deduct their pro rata share of R&D limited partnership's loss resulting from partnership's § 174 deduction); supra note 9 (discussion of partnership taxation).
federal courts nor the I.R.S. has ruled whether a R&D limited partnership serves a legitimate business purpose. The recent Tax Court decision in *Helliwell v. Commissioner,* however, challenges the legitimacy of R&D limited partnerships. In *Helliwell,* a limited partnership contracted to produce two motion pictures for World Film Services (WFS). WFS was an established motion picture production company that was experiencing difficulty borrowing money. WFS was to pay the limited partnership a fee for producing the motion pictures that was in part contingent on the commercial success of the motion pictures. The general partners of the limited partnership, a group of investors with no experience producing motion pictures, hired the officers and employees of WFS to produce the motion pictures. Although both WFS and the limited partnership obtained loans to finance the motion pictures, only WFS provided security for the loans which were nonrecourse against the limited partnership. The controversy arose when a limited partner in the limited partnership attempted to deduct his pro rata share of the partnership’s losses incurred in producing the motion pictures. The Commissioner denied the taxpayer’s deduction and the taxpayer appealed.

The Tax Court in *Helliwell* stated that the limited partnership’s sole purpose was to provide financing for WFS, and that the partnership merely purchased a net profits interest in the motion picture because WFS and not the limited partnership was the actual producer of the motion pictures. The Tax Court held that the limited partnership was a sham because WFS was the same entity that actually produced the motion pictures and because the sole purpose of WFS’s relationship with the limited partnership was to receive inexpensive financing for its motion pictures in exchange for shifting the tax benefit of the net operating loss deduction to the limited partners. The Tax Court consequently denied the taxpayer a deduction for his pro rata share

70. See *supra* notes 68 and accompanying text (discussing regulations accompanying § 174).
71. 77 T.C. 964 (1981).
72. *Id.*; see Taft, *Trouble for Tax Shelters,* 187 N.Y.L.J. at 1, col. 1 (Feb. 17, 1982). The Tax Court will analyze tax shelter limited partnerships to determine whether the limited partnership serves a legitimate business purpose other than to shift the tax benefits onto the limited partners. *Id.*; see also *supra* note 55 (discussion of cases in which taxpayer’s transaction served no legitimate business purpose).
73. 77 T.C. at 965, 970.
74. *Id.* at 967.
75. *Id.* at 971.
76. *Id.* at 985, 986.
77. *Id.* at 973. In *Helliwell,* the lender required World Film Services (WFS) to be prime obligor on the loans and did not require the limited partnership to assume personal liability for the loan. *Id.* at 976. WFS as the primary obligor for the loans had a direct and absolute duty to repay the loans. See L. Simpson, *Handbook of the Law of Suretyship* 5 (1950) (primary obligors on debt have absolute duty to repay debt).
78. 77 T.C. at 964.
79. *Id.* at 965. The Commissioner in *Helliwell* denied the taxpayer’s deduction because the taxpayer’s limited partnership did not produce the motion pictures but merely purchased a net profits interest in WFS’s motion pictures. *Id.* at 982.
80. *Id.* at 991.
81. *Id.*
of the partnership's net operating loss. Although the *Helliwell* court noted that in theory a production service partnership is a valid business arrangement, the court held that the particular arrangement in *Helliwell* was a sham because of the parties' overlapping relationships.

The structure of the *Helliwell* partnership is similar to a R&D partnership because both contain limited partners investing in a general partner's project. After the *Helliwell* decision the courts or the I.R.S. may characterize a R&D limited partnership as a sham if the parties in the R&D limited partnership have similar overlapping relationships. WFS's position in *Helliwell*, WFS had the ideas for two motion pictures and attempted to raise the capital to produce a finished product. Although WFS was not the general partner in *Helliwell*, WFS had the unlimited liability of a general partner because WFS was the primary obligor on the loans made to the limited partnership. The general partners in *Helliwell*, however, had limited liability on the loans because the loans were nonrecourse against the general partners. Furthermore, the producer in a production partnership like *Helliwell* is similar to a R&D contractor because both entities carry on the day to day activities necessary to produce an end product. Since the Tax Court held that the *Helliwell* partnership was a sham because the producer and the general partner were the same entity, a R&D limited partnership in which the general partner and the R&D contractor are the same entity may also be a sham.

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82. Id.
83. Id. The *Helliwell* Court noted that a limited partnership could produce a motion picture and that the limited partners could deduct their pro rata share of the net operating loss. *Id.; see* I.R.C. § 172(c) (1976) (net operating loss is excess of taxpayer's allowable deductions over taxpayer's gross income); *supra* note 9 (discussion of partnership taxation).
84. *See supra* note 1 and accompanying text (passive investors as limited partners invest in promoter's or general partner's project); *see also* *Helliwell*, 77 T.C. at 983 (production service limited partnership consists of investors contributing cash to finance production of general partner's movie).
85. *See infra* text accompanying notes 86-90 (discussion of potential similarities between R&D limited partnership and *Helliwell* partnership).
86. *See supra* text accompanying note 12 (promoters transfer to R&D partnership all rights in exchange for general partner's interest in R&D limited partnership); *supra* note 1 (general partners typically need financing to finish or begin project that general partner started or conceived); *see also* *Helliwell* v. Commissioner, 77 T.C. 964, 968 (1981) (WFS needed capital to finish two motion pictures).
87. 77 T.C. at 967, 968.
88. *See supra* note 18 (general partners in limited partnership have same liability as partners in partnership without limited partners); *Uniform Partnership Act* § 15(b) (1914) (all partners in partnership are jointly liable for all debts and obligations of partnership); *see also supra* note 77 and accompanying text (discussion of WFS liability on loans to *Helliwell* partnership).
89. *See supra* note 77 and accompanying text (discussion of limited partnership's liability on loans to *Helliwell* partnership).
90. *See* *Helliwell* v. Commissioner, 77 T.C. 964, 967 (1981) (producer performs the "bricks and mortar" of motion picture); *supra* note 1 (R&D contractor performs actual research and experimentation in R&D limited partnership).
91. *See* 77 T.C. at 991 (WFS was actual producer of motion pictures).
In addition to the threat the Helliwell decision presents to R&D limited partnerships, the Supreme Court’s decision in Knetsch v. United States⁹² questions the deductibility of a R&D limited partnership’s R&D expense deduction.⁹³ In Knetsch the taxpayer purchased 4,004,000 dollars worth of deferred annuity savings bonds bearing 2½ percent interest.⁹⁴ The taxpayer paid for the bond with 4,000 dollars cash and a 4,000,000 dollars nonrecourse annuity note which bore 3½ percent interest and was secured by an annuity savings bond.⁹⁵ The taxpayer prepaid the first year’s interest on the annuity note and claimed a deduction for the amount of interest the taxpayer paid or accrued on indebtedness during the tax year.⁹⁶ The insurance company that sold the taxpayer the annuities permitted the taxpayer to borrow against the yearly increase in the case value of the bonds.⁹⁷ The taxpayer periodically borrowed against the bonds so that the net cash value of the bonds at maturity would be 1,000 dollars.⁹⁸ The Commissioner, however, characterized the taxpayer’s

⁹³. Id. at 361.
⁹⁴. Id. at 363; see Blum, Knetsch v. United States: A Pronouncement on Tax Avoidance, 1961 Sup. Cr. Rev. 135, 137 n.8 (1961) (explaining taxpayer’s tax avoidance scheme in Knetsch). In 1953 the taxpayer paid in cash a net amount of $48,465. 364 U.S. at 363. In 1953 the taxpayer deducted $143,465 as interest expense. Id. When the taxpayer surrendered the bonds, the cash value of the bonds exceeded the taxpayer’s indebtedness by $1,000. Id. at 364. The taxpayer continued borrowing against the bond’s increased cash value in 1954 and 1955. Id. at 362-363. Over the entire transaction the taxpayer paid the insurance company $441,315 in interest, and the taxpayer received $308,000 in interest plus the $1000 cash surrender value of the bonds. Id. at 364; see also Blum, supra at 137 n.8. The taxpayer expended $137,315 on the transaction, which included the taxpayer’s $4,000 initial investment plus the $133,315 difference between the taxpayer’s payments and the cash the taxpayer received. Blum, supra at 137 n.8. According to the tax laws at the time if the taxpayer were in the 90% bracket, the taxpayer’s net costs would have been the initial cash investment ($4000) and 10% of the total interest paid (.10 X $441,315 = $44,131.50) for a total of $48,131.50. Id.; see also I.R.C. § 1 (1954) (marginal rate on income in excess of $150,000 but less than $200,000 was 90%). Furthermore, assuming that the taxpayer could realize a long term capital gain on the increase in cash value of the bonds, the net amount the taxpayer received after taxes, therefore, would have been $192,868.50, which would be a 140% return on the taxpayer’s investment. Blum, supra, at 137 n.8.

⁹⁵. 364 U.S. at 362-63.
⁹⁶. I.R.C. § 1634(a) (1983) (allows taxpayers a deduction on all interest the taxpayer pays or accrues during tax year). In Old Colony Railroad Co. v. Commissioner, the Supreme Court defined interest as the amount of money one party has contracted to pay for the use of borrowed money, and also the compensation received for the lending of money. 284 U.S. 552, 560 (1932); see Rev. Rul. 69-188, 1969-1 C.B. 54, 54 (payment qualifies as interest if compensation for use or forbearance of money and not merely payment for services lender performed in connection with borrower’s loan).

⁹⁷. Knetsch 364 U.S. at 363. In Knetsch the increase in cash value of the bonds in the first year was $100,000 (.025 X $4,000,000). See Blum, supra note 94, at 137 n.8 (explaining taxpayer’s tax avoidance scheme in Knetsch). The taxpayer borrowed $99,000 against the bond’s $100,000 increased cash value. Id. The taxpayer gave the insurance company a 3.5% note for the loan and prepaid $3,465 in interest on the $99,000 loan. Id.; see supra note 94 (discussion of taxpayer’s tax avoidance scheme in Knetsch).

⁹⁸. 364 U.S. at 364.
transaction as a sham thereby disallowing the taxpayer's section 163(a) deduction and determining that a deficiency existed on the taxpayer's 1953 and 1954 tax returns.\textsuperscript{99} The taxpayer paid the deficiency and sued for a refund.\textsuperscript{100} The district court for the Southern District of California and the Ninth Circuit upheld the Commissioner's decision that the taxpayer's transaction was a sham.\textsuperscript{101}

On appeal the Supreme Court stated that the issue in \textit{Knetsch} was whether Congress intended the interest deduction of I.R.C. § 163(a) to apply to the payments the taxpayer made to the insurance company.\textsuperscript{102} The Supreme Court noted that the taxpayer's purchase took the form of an annuity contract with a guaranteed cash surrender value at maturity of 8,388,000 dollars.\textsuperscript{103} The contract would produce either monthly payments of 90,171 dollars or life insurance proceeds payable on the taxpayer's death.\textsuperscript{104} The Court stated that the fund would have been insufficient to pay either the annuity payments or the insurance proceeds because the taxpayer's borrowings kept the net cash value of the annuity at only 1,000 dollars.\textsuperscript{105} Since in substance the only possible economic benefit the taxpayer could achieve from the transaction was an interest deduction under section 163(a), the Supreme Court held that the taxpayer's transaction was a sham.\textsuperscript{106}

Since the Supreme Court in \textit{Knetsch} stated that in substance a taxpayer's transaction must provide the taxpayer with benefit other than a tax benefit, a R&D limited partnership must provide investors with more than mere tax benefits.\textsuperscript{107} A major objective of a R&D limited partnership, however, is to

\begin{itemize}
  \item \textsuperscript{99} Id. at 362.
  \item \textsuperscript{100} Id.
  \item \textsuperscript{101} Id. The Court granted certiorari in \textit{Knetsch} because of a suggested conflict between the Fifth Circuit's decision in \textit{United States v. Bond}, 258 F.2d 577 (5th Cir. 1958) and the Ninth Circuit's decision in \textit{Knetsch}, 272 F.2d 200 (9th Cir. 1959). 364 U.S. at 362. In \textit{Bond}, the taxpayer bought a single premium 30 year annuity savings bond from an insurance company. 258 F.2d at 578. The taxpayer paid for the bond with a note on which he prepaid the interest in advance. Id. The bond provided that at any time before the maturity date of the bond the taxpayer could receive in a lump sum the cash value at maturity less any indebtedness the taxpayer owed the insurance company on the note. Id. at 579. The Ninth Circuit held that the transaction was not a sham because the money the taxpayer paid satisfied the Supreme Court's definition of interest. Id. at 584; see \textit{Old Colony R.R. Co. v. Commissioner}, 284 U.S. at 560 (interest is compensation for use or forbearance of money). The transaction in \textit{Bond} differs from the transaction in \textit{Knetsch}, because in \textit{Bond} the taxpayer did not borrow against the bond's increased cash value. 364 U.S. at 362. Changes in the tax code have made both the taxpayer's transactions in \textit{Bond} and \textit{Knetsch} less attractive. See I.R.C. § 264(a)(2) (1976) (denies taxpayer deduction for interest paid or accrued on single premium annuity contracts).
  \item \textsuperscript{102} 364 U.S. at 365-66 (court noted taxpayer obviously would not receive anything from taxpayer's transaction beyond tax deduction).
  \item \textsuperscript{103} Id. at 365.
  \item \textsuperscript{104} Id.
  \item \textsuperscript{105} Id. at 366; see supra note 94 (discussion of taxpayer's borrowing against bond's increased cash value). The \textit{Knetsch} Court noted that rather than lending taxpayer money based on the bond's increased cash value, the insurance company actually only rebated to the taxpayer a substantial portion of the taxpayer's prepaid interest. Id. at 366.
  \item \textsuperscript{106} Id. at 366.
  \item \textsuperscript{107} Id.
\end{itemize}
shift the tax benefit of the limited partnership’s R&D expense deduction to passive investors. In *Knetsch* the taxpayer’s transaction was a sham because the sole purpose of the transaction was to generate an interest deduction. If a court determines that the sole purpose of a R&D limited partnership is to generate a tax deduction, the court could characterize the R&D limited partnership as a sham. Consequently, the very tax benefits that make a R&D limited partnership attractive to investors render the partnership susceptible to characterization as a sham transaction.

According to the *Helliwell* and *Knetsch* cases, the issue in determining if a R&D limited partnership is a sham is whether a R&D limited partnership exalts form over substance. Although a R&D limited partnership in substance merely serves to provide a tax shelter to passive investors, the form used to create the shelter promotes the public purpose of funding R&D projects. The current demand for highly technical products such as semiconductors, and the United States’ declining market position as a manufacturer of highly technical products has increased the need for domestic research and development. If the courts or the Commissioner were to characterize R&D

108. See Birnbaum, supra note 1, at 48 (R&D limited partnerships provide current deduction and possibility of long term capital gains on the investor’s income).

109. See supra text accompanying notes 106-107 (taxpayer did not have business purpose to support transaction).

110. See supra text accompanying notes 106-107 (courts would characterize R&D limited partnership as sham if courts found that motivation behind R&D limited partnership is analogous to taxpayer’s motivation in *Knetsch*).

111. See supra text accompanying note 108 (tax avoidance potential make R&D limited partnerships attractive).

112. See *Knetsch*, 364 U.S. at 367 (in reality taxpayer’s transaction did not comport with intent of statute); *Helliwell v. Commissioner*, 77 T.C. 964, 990 (1981) (taxpayer actually received net profits interest in motion picture and did not produce motion pictures).

113. See supra notes 16-22 and accompanying text (discussion of advantages for promoters and inventors of R&D limited partnerships). In some areas of tax law, compliance with form is sufficient to validate a tax arrangement. See Blum, supra note 94, at 146 (wash sales under § 1091 in which taxpayer does not recognize gain or loss will not be upset regardless of taxpayer’s motive behind sale; I.R.C. 1091 (1976) (special treatment for taxpayers transactions in stock or securities when taxpayer buys or sells identical stock or securities within 30 day period). A taxpayer whose capital losses exceed capital gains therefore is free to sell an amount of stock at a gain and subsequently repurchase the same amount of stock at a new higher selling price. Blum, supra note 93 at 146. The effect of the wash sale is to increase the taxpayer’s basis in the stock. Id. at 147.

The one year holding period for capital gains treatment is another example where the form of a taxpayer’s transaction is more important than its substance. Id. at 147. A taxpayer who holds a capital asset for 365 days before selling the asset will have a short term gain or loss on the sale of that asset. See I.R.C. § 1222 (1) & (2) (1976) (short term gains or losses result from exchanges of capital assets held not more than one year). If the same taxpayer held the asset for one more day, the taxpayer would have a long term gain or loss on the sale of that asset. See I.R.C. § 1222 (3) & (4) (1976) (holding period of assets for long term capital gains or losses is over one year).

114. See Chase, *U.S. Electronics Firms Consider Joining in Research Venture to Counter Japanese*, Wall Street Journal, March 1, 1982, at 39, col. 2. Sixteen major computer and semiconductor companies are discussing plans to form a joint venture for research in materials science,
limited partnerships as mere corporate financing and consequently deny the tax deduction, the courts and the I.R.S. would thwart the legislative intent of encouraging R&D investments. Furthermore, the arrangements involved in *Helliwell* and *Knetsch* differ from a R&D limited partnership because the arrangements in *Helliwell* and *Knetsch* were not supported by specific legislative purposes. R&D limited partnerships, however, promote the legitimate purpose of encouraging R&D investment, and as long as the R&D limited partnership is actually investing in research and development the courts should not hold that the R&D limited partnership’s sole purpose is tax avoidance.

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115. See supra note 66 (discussion of congressional desire to stimulate research and development).


117. See supra notes 115-116 and accompanying text (R&D limited partnerships are natural result of express statutory provisions).