IN THE UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 94-40798

MACH-TECH, LTD. PARTNERSHIP and SERV-TECH, INC.,

Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the Tax Court of the United States
(6529-92)

June 16, 1995

Before JOLLY and BARKSDALE, Circuit Judges, and FELDMAN[*], District Judge.

E. GRADY JOLLY, Circuit Judge:[**]

Serv-Tech, Inc. ("Serv-Tech"), the tax matters partner for Mach-Tech, Ltd. Partnership ("Mach-Tech"), appeals the Tax Court's disallowance of Mach-Tech's deduction for research and development expenses under 26 U.S.C. § 174 for the years 1983 and 1985.

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[*]District Judge, of the Eastern District of Louisiana, sitting by designation.

[**]Local Rule 47.5 provides: "The publication of opinions that have no precedential value and merely decide particular cases on the basis of well-settled principles of law imposes needless expense on the public and burdens on the legal profession." Pursuant to that Rule, the court has determined that this opinion should not be published.

Because we hold that Mach-Tech neither was engaged in a trade or business, nor had a realistic prospect of engaging in a trade or business during the years at issue, we affirm the Tax Court's ruling.

I

The Internal Revenue Code, 26 U.S.C. § 174, provides that "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." 26 U.S.C. § 174(a)(1). The costs represent "research and development costs in the experimental or laboratory sense." 26 C.F.R. § 1.174-2(a)(1).

A small body of case law has developed interpreting § 174. Courts have determined that a taxpayer can meet the "connection to business" test even though the taxpayer did not produce or sell a product at the time the expenditures were incurred, if the taxpayer is engaged in trade or business at any time and the deducted expenditures were incurred with respect to that business. Snow v. Commissioner, 416 U.S. 500, 94 S.Ct. 1876 (1974). Furthermore, a deduction under § 174 also may be allowed if it is determined that there was a "realistic prospect" that the technology developed will or would have been exploited in the taxpayer's trade or business. See Zink v. United States, 929 F.2d 1015, 1022-23 (5th Cir. 1991); Diamond v. Commissioner, 930 F.2d 372, 375 (4th Cir. 1991). The

courts have closely scrutinized claimed research and development expenditures, particularly those claimed by partnerships, to separate those that are legitimate from those that are merely designed to shelter the income of passive investors. See, e.g., Harris v. Commissioner, 16 F.3d 75, 80-82 (5th Cir. 1994).

We employ a de novo standard of review in examining the Tax Court's legal conclusions, including its interpretations of the Internal Revenue Code. Harris, 16 F.3d at 81. We must, however, accept the Tax Court's findings of fact unless they are clearly erroneous. Id. In this appeal, the question is whether the Tax Court was clearly erroneous in finding that in 1983 and 1985 there was no realistic prospect that Mach-Tech could use the technology it had developed in connection with its trade or business.

II

After considering the record, briefs, and arguments, we have reached the conclusion that the Harris analysis controls this case. Accordingly, we find that the Tax Court was not clearly erroneous in its findings of fact, nor did it commit reversible error in its legal reasoning. Our basis for reaching this result is outlined below.

A

We first undertake Serv-Tech's challenges to the Tax Court's findings of fact. Serv-Tech first argues that the Tax Court erred in determining that Mach-Tech was not engaged in a trade or business during the years at issue. Second, Serv-Tech contends

that the Tax Court erred in determining that there was no "realistic prospect" that Mach-Tech would engage in a trade or business relating to the cleaning system. Despite Serv-Tech's arguments to the contrary, we are persuaded that when the Tax Court examined the "economic realities of the financial arrangement" in this case, it could reach only the conclusion of nondeductibility. See Harris, 16 F.3d at 79.

With respect to whether Mach-Tech was engaged in a trade or business, the capital contributed by the partners upon the formation of Mach-Tech was immediately funneled to a research and development company, which was a subsidiary of Serv-Tech. During the years in question, Mach-Tech had no employees. Furthermore, it is not even clear that Richard Krajicek, a major partner in Mach-Tech, co-inventor of the technology, and president of Serv-Tech, was acting on behalf of the partnership of Mach-Tech in his business activities for the years in question, 1983 and 1985. Considering these and other relevant facts reflected in its thorough opinion, the Tax Court did not err in its determination that Mach-Tech was not engaged in a trade or business during 1983 and 1985.

Furthermore, the Tax Court was not clearly erroneous in its finding that there was no "realistic prospect" that Mach-Tech would engage in a trade or business relating to the cleaning system. The existence of Serv-Tech's right of first refusal option, as well as the non-existence of a business plan in the event that Serv-Tech

did not exercise its option, also serve to convince us that the Tax Court was correct in its findings. Still further, the record is not convincing that the partners, without Serv-Tech, realistically could have marketed the product. Thus, the Tax Court did not clearly err when it found that Mach-Tech was not involved in a trade or business, that it did not have a "realistic prospect" of engaging in one, and that the evidence demonstrated that the research and development indeed would be exploited through *another's* business.

B

We next turn to Serv-Tech's argument that the Tax Court committed legal error by misinter5
preting *Snow v. Commissioner*, 416 U.S. 500 (1974). Serv-Tech argues that the Tax Court erroneously imposed an additional restriction on Mach-Tech by mandating that the partnership itself exploit the technology in order to meet the requirements of § 174. The Mach-Tech partnership sold their partnership interests to Serv-Tech for 7.5% interest in Serv-Tech, which marketed the technology. As was suggested at oral argument, Serv-Tech's argument stretches the meaning and intent of *Snow*, while refusing to recognize the significance of *Harris*. In *Snow*, which allowed the deduction under § 174, the partnership that conducted the research and development eventually incorporated so that it could market and exploit the technology. Serv-Tech analogizes its situation to that in *Snow*: Acknowledging that Mach-Tech's partners have only 7.5% interest in

Serv-Tech that they received when they sold their partnership interests (and, thus, the technology) to Serv-Tech, they argue that because the actions of Serv-Tech on behalf of the product can be attributed to the former partners of Mach-Tech, they are entitled to the deduction. This argument ignores Harris's requirement of an "operational nexus"; that is, "the degree of 'connection' required between the expenditures and the operation of the trade or business itself." Harris, 16 F.3d at 78. In Harris's "broad spectrum of financial arrangements," Mach-Tech's relationship with Serv-Tech falls toward the end of the spectrum of financial arrangements that function merely as "investment vehicle[s] that cannot deduct the cash paid to the corporation under section 174 even if the corporation used that very cash to fund its research expenditures." Id. According to Harris, a dispositive factor in cases determining whether a § 174 deduction is warranted is whether "the entity that incurred the research expenses actually managed and actually controlled the use or marketing of the research results." Id. at 80. Despite Serv-Tech's "attribution" arguments, it is clear that the Tax Court did not err in finding that Mach-Tech, with its 7.5% interest in Serv-Tech after the merger, could not exercise the control over the exploitation of the technology as required by Snow and Harris. Thus, even though Serv-Tech characterizes this aspect of their appeal as a legal issue, it was a determination of fact by the Tax Court, which we do not find to be clearly erroneous.

III

In sum, the Tax Court was not clearly erroneous in finding that Mach-Tech was not engaged in a trade or business, and that it did not have a realistic prospect of engaging in a trade or business during the years of 1983 and 1985. Furthermore, we find that the Tax Court did not err in its determination that Mach-Tech did not maintain the requisite control over the technology after the merger to entitle it to the deduction under § 174. For the foregoing reasons, the judgment of the Tax Court is

A F F I R M E D.